TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1962

No. 476

BENJAMIN BRAUNSTEIN, ET AL., PETITIONERS,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED OCTOBER 1, 1962

CERTIORARI GRANTED DECEMBER 10, 1962

SUPREME COURT OF THE UNITED STATES

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INDEX

RECORD PRESS, PRINTERS, NEW YORK, N. Y., JANUARY 21, 1963

[fol. 1]

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 27146, 27147 and 27148

BENJAMIN BRAUNSTEIN and DIANA BRAUNSTEIN; BENJAMIN NEISLOSS and JULIA NEISLOSS; HARRY NEISLOSS and LILLIAN NEISLOSS, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

On appeal from a decision of the Tax Court of the United States.

APPENDIX TO PETITIONERS' BRIEF

[fol. 43]

IN THE TAX COURT OF THE UNITED STATES

STIPULATION OF FACTS

The parties, by their respective counsel, stipulate that the following facts are true and are to be considered as [fol. 44] evidence, without prejudice to the right of either party to introduce additional evidence not inconsistent with the facts stipulated herein, and without prejudice to either party to object to the relevance or materiality of any fact stipulated herein.

* * * * * * *

[fol. 45]

* * * * * * *

32. * * *

The basis for depreciation of buildings, shown on Springfield's income tax return, for the year ended August 31, 1950, Exhibit 8-H, is $3,919,039.29, which represents the

cost of the Springfield project, $4,069,007.82 above, less the sum of $147,354.99 deducted as interest, and $2,613.54 deducted as real estate taxes.

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[fol. 46]

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61. * * *

The basis for depreciation of buildings, shown on Hill's income tax return, for the year ended January 31, 1951, Exhibit 39-MM, is $1,822,727.42, which represents the cost of the Hill project, $1,872,834.53 above, less the sum of $48,503.88, deducted as interest, and $1,604.03 deducted as real estate taxes.

* * * * * * *

[fol. 49]

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85. Petitioners Benjamin Braunstein, Benjamin Neisloss and Harry Neisloss also owned the stock of other corporations which secured loans which were insured by the FHA under Section 608 of the National Housing Act as amended. Attached hereto as Exhibit 72-TTT and made a part hereof is a schedule containing the names of such other corporations, the dates construction was completed, and the dates of sale of petitioners' stock in such corporations.

* * * * * * *

[fol. 78]

Exhibit 72-TTT

OTHER PROJECTS IN WHICH BENJAMIN NEISLOSS, HARRY NEISLOSS AND BENJAMIN BRAUNSTEIN WERE INTERESTED

Name	*Construction Completed*	*Date of Sale*
Brookside Gardens, Inc.	January 1, 1948	Sold to One Purchaser May 15, 1953
Madison Gardens, Inc.	February 1, 1944	
Somerset Homes, Inc.	March 1, 1943	
Somerville Gardens, Inc.	September 1, 1943	
Monroe Gardens, Inc.	November 1, 1945	November 30, 1949

EXCERPT FROM JOINT EXHIBIT 4-D

CERTIFICATE OF INCORPORATION
OF
SPRINGFIELD DEVELOPMENT CO., INC.

* * * * * * *

[fol. 78a]

Eighth: The corporation shall not without prior approval of the holders of a majority of the shares of the preferred stock given either in writing or by vote at a meeting of the preferred stockholders called for that purpose (a) assign, transfer, dispose of or encumber any real or personal property, including rents, except as specifically permitted by the terms of the mortgage, (b) remodel, reconstruct, demolish or subtract from the premises constituting the project and subject to such mortgage (c) permit the occupancy of any of the dwelling accommodations of the corporation except at or below the rents fixed by the schedule of rentals provided hereinafter, (d) consolidate or merge the corporation into or with any other corporation; go into voluntary liquidation; carry into effect any plan of reorganization of the corporation; redeem or [fol. 78aa] cancel any of its shares of preferred stock, or effect any changes whatsoever in its capital stock; alter or amend the certificate of incorporation or fail to establish and maintain reserves as set forth in this certificate of incorporation.

* * * * * * *

EXCERPT FROM JOINT EXHIBIT 34-HH

CERTIFICATE OF INCORPORATION
OF
HILL DEVELOPMENT CO., INC.

* * * * * *

[fol. 78b]

Eighth: The corporation shall not without prior approval of the holders of a majority of the shares of the preferred stock, given either in writing or by vote at a

meeting of the preferred stockholders called for that purpose (a) assign, transfer, dispose of or encumber any real or personal property, including rents, except as specifically permitted by the terms of the mortgage, (b) remodel, reconstruct, demolish or subtract from the premises constituting the project and subject to such mortgage, (c) permit the occupancy of any of the dwelling accommodations of the corporation except at or below the rents fixed by the schedule of rentals provided hereinafter, (d) consolidate or merge the corporation into or with any other corporation; go into voluntary liquidation; carry into effect any [fol. 78bb] plan of reorganization of the corporation; redeem or cancel any of its shares of preferred stock, or effect any changes whatsoever in its capital stock; alter or amend the certificate of incorporation or fail to establish and maintain reserves as set forth in this certificate of incorporation.

* * * * * * *

[fol. 91]

IN THE TAX COURT OF THE UNITED STATES

EXCERPTS FROM PROCEEDINGS

(From the official transcript of the testimony before the Tax Court at the hearings held on November 15, and 16, 1957, as corrected by the Joint Stipulation of the Parties filed with the Tax Court on March 10, 1958).

* * * * * * *

[fol. 96] BENJAMIN NEISLOSS was called as a witness on behalf of the Petitioners, and having been first duly sworn, testified as follows:

The Clerk: State your name.

The Witness: I am Benjamin Neisloss, 110-06 70th Road, Forest Hills, New York.

Direct examination.

By Mr. Eisenstein:

Q. Mr. Neisloss, are you one of the petitioners in this case?

A. I am.

Q. Are you related to Harry Neisloss?

A. Yes, we are brothers.

Q. Are you related to Benjamin Braunstein?

A. No, sir.

Q. Is your brother Harry related to Mr. Braunstein?

A. No, sir.

Q. When did you first get to know Mr. Braunstein?

A. In 1930.

Q. What is your occupation?

A. I am in real estate.

[fol. 97] Q. What is your brother Harry's occupation?

A. Same occupation.

Q. Can you tell us what Mr. Braunstein's occupation is?

A. He is a professional architect. He also engages in real estate on occasion.

Q. How long have you been engaged in the real estate field?

A. 38 years.

Q. Where would that place the beginning now?

A. In 1919, right after the First World War.

Q. I would like you to summarize your activities in real estate between 1919 and 1930 when you say you met Mr. Braunstein.

A. My brother and I engaged in the construction of one-family homes on Long Island.

Q. Did you engage in the construction of any other type of property?

A. Yes, we did some general contract work.

Q. You indicated just now that you and your brother engaged in the construction of individual dwellings?

A. That is correct.

Q. Did you and your brother construct and sell those dwellings as individuals or corporation?

A. At that time, yes, as individuals.

Q. As individuals?

A. Prior to 1938.

Q. Do you remember more precisely where you built these homes?

A. We built them in Hollis and in Bayside, Long Island. Both places are in Long Island.

Q. How were the gains reported, as ordinary income in this or capital gain?

A. Ordinary income.

Q. Did the two of you, your brother and you, operate as a partnership?

A. Yes, just as brothers.

Q. Did you have any formal partnership arrangement?

A. No, sir.

Q. Did the two of you—well, you have indicated that you did some other kind of building in the period 1919 to 1930. Now we would like you to indicate more precisely what that building consisted of.

A. Well, in 1926, we bought a piece of property on Bell Avenue, Bayside. When I say "we", it was my brother [fol. 98] and I through a corporation, Bell Avenue Holding Corporation. They were altered and built some new stores to that.

Q. Who were the stockholders in that corporation?

A. Myself and my brother.

Q. How did you own the stock—

A. How—

Q. In what proportions?

A. 50-50, half and half.

Q. Does that Bell Corporation still own the property?

A. No, it does not, sir.

Q. What happened to it?

A. In 1929, we were victims of the depression. The tenants moved out and we deeded the property back to the mortgagee.

Q. Did you and your brother put up any other properties in the period 1919 to 1930?

A. We bought some properties I remember in Jamaica, some business property, also about 1926 some business property, stores on Jamaica Avenue.

Q. Did you buy that individually or through a corporation?

A. Corporation.

Q. What was the name of it?

A. Neisloss Brothers, Inc.

Q. Can you tell us about when it was organized?

A. It was organized about 1923, I believe.

Q. When did the corporation acquire these properties? I don't think you were very precise.

A. Are you referring to the property on Jamaica Avenue?

Q. I am referring to the properties which were acquired about 1923, I believe you said.

A. In 1923 and 1924 we bought several parcels of land in Bayside with the view of developing.

Q. When you say "we"—

A. My brother and myself.

Q. As individuals?

A. No, through the corporation.

Q. What did the corporation do with those properties?

A. They finally sold them in 1926.

Q. Did the corporation sell them?

A. The corporation sold them.

Q. Did the corporation realize a gain?

A. Some gain.

[fol. 99] Q. Did the corporation report that gain?

A. Yes, sir.

Q. Did you do any other construction work in that period?

A. You are talking now—

Q. 1919 to 1930 for persons other than yourselves?

A. Yes, we did several small construction jobs.

Q. Does Neisloss Brothers, Inc., still exist?

A. No, it does not, sir.

Q. Now, I would like you to summarize your real estate activities from 1930, the time when you met Mr. Braunstein until the beginning of World War II.

A. Well, in 1930, we met Mr. Braunstein, and he designed a group of apartments for us in Bayside. When I say "we", it was the Benhar Holding Company. He designed and we built that project in 1930, yes, 1930 to 1931.

Q. Did that project have any particular name?

A. Hawthorne Court.

Q. It was owned by Benhar Holding Corporation? What type of apartments?

A. Garden type.

Q. Who owned the stock of Benhar?

A. Myself and my brother.

Q. In equal shares?

A. Yes.

Q. What happened to that project?

A. We built that project, we sold that project in 1946.

Q. When you say you sold the project, do you mean you sold the stock or the corporation sold the assets?

A. We sold the stock.

Q. Did the stockholders report a gain on that, sir?

A. Yes, we did.

Q. Do you know whether the gain was reported as capital gain or ordinary income?

A. I believe it was capital gain.

Q. Did the Treasury ever question that?

A. No, sir.

Q. Will you tell us why the stock was sold at that time?

A. We had a good offer, we were very busy in Bayside at the time, this took some of our time, so we decided to take it.

Q. What other construction did you do from 1930 to World War II?

A. About 1934 we went back to the building business. We were out of it for a while.

[fol. 100] Q. When you say building business, what do you mean?

A. Construction. In 1934 and 1935, my brother and I purchased some individual parcels in Bayside and we built some one-family dwellings for sale. Then in 1935, the early part of 1936, we acquired a tract of land in Bayside and there we built one hundred homes, 1936, 1937 and 1938.

Q. When you say "we", you mean you built them as an individual?

A. No, we had a corporation known as the Lawrence Village Homes, Inc.

Q. Who owned that?

A. My brother and myself.

Q. In equal shares?

A. Yes.

Q. Did the Lawrence Village Corporation sell those homes?

A. Yes.

Q. Did the corporation report a gain?

A. Yes.

Q. Did it report the gain as ordinary income or capital gain?

A. Ordinary income.

Q. Did the Lawrence Village Corporation do anything else?

A. Yes. The Lawrence Village Corporation constructed a business building in Nassau County for someone else.

Q. Is the Lawrence Village Corporation still in existence?

A. No, sir, it is not.

Q. Was it liquidated?

A. Yes.

Q. About when?

A. About 1938 to 1939.

Q. Can you tell us of any other building or construction that you did?

A. During that period in 1938, we acquired a parcel of land in Jamaica. In 1936 or 1937 we acquired the land and in 1938 we built a large apartment house there. When I say "we", we formed a holding corporation in which Mr. Braunstein became one of the stockholders, together with myself and my brother.

Q. Did you own the stock in three equal shares?

A. Yes, sir.

Q. About when was that project completed?

A. It was completed in the fall of 1938.

Q. Does the corporation still own the apartment house?

A. No, it does not.

[fol. 101] Q. What happened to it?

A. It was sold in 1941.

Q. When you say it was sold, who sold it?

A. There I believe the corporation sold it.

Q. You say the corporation sold it?

A. Yes.

Q. You did not sell the stock?

A. No, sir.

Q. Did the corporation report a gain?

A. Yes, it did.

Q. Was that corporation liquidated or is it still in existence?

A. I believe it was liquidated, yes, sir.

Q. What other construction did you do?

A. Then during that period of 1938, my brother and I built a row of stores in Hollis. We formed the Hillburn Holding Corporation. There it was my brother and myself.

Q. In equal shares?
A. Yes, we built these stores in 1938.
Q. Is that property still held by the corporation?
A. No.
Q. What happened to it?
A. In 1948, yes, in 1948 we sold the stock in that corporation.
Q. Did you and your brother report a capital gain?
A. Yes, sir.
Q. Has that gain ever been questioned?
A. No, sir.
Q. Can you tell us whether there was any other building or construction from about 1930 to World War II?
A. Yes, sir, we acquired in 1938 a tract of land in Bayside. We purchased it from Wesleyan University.
Q. What year?
A. 1938, prior to the war we bought that.
Q. Where was that parcel located?
A. In Bayside, Long Island.
Q. When you say it was bought, who precisely bought it?
A. Myself, my brother and Benjamin Braunstein formed the Weeks-Woodlands, Inc.
Q. What did that corporation do with the acquired land?
A. It erected one hundred or more one-family dwellings.
Q. Were those dwellings erected for sale?
A. Yes, sir.
Q. Did the corporation sell the homes?
A. Yes, sir, it did.
[fol. 102] Q. Did the corporation report any gain on the sale?
A. Yes, sir.
Q. Was the gain reported as ordinary income or capital gain?
A. Ordinary income.
Q. Is that corporation still in existence?
A. No, sir.
Q. Has it been liquidated?
A. Liquidated after final sale.
Q. Do you recall any other real estate activity or construction activity in the period between 1930—1930 and World War II?
A. No, I do not.

Q. What is your answer?

A. I don't remember for the moment.

Q. Were any of these homes that were built by Weeks-Woodland financed through loans insured by the FHA?

A. Yes, they were.

Q. About how many?

A. About 60 per cent of them.

Q. That brings us up to World War II. I want you to summarize the real estate activities of yourself, your brother and Mr. Braunstein during the Second World War and to the end of 1947.

A. Well, when the priorities came into existence in 1942, we looked around for something to do, we went down to Virginia, then we went to the Jersey office of the FHA and we were directed to go down to Somerville, New Jersey. There was a great need for war housing down there.

Q. You mentioned an FHA office. Where was it?

A. Newark, New Jersey.

Q. Then what did you do?

A. We took options on several pieces of land down there, submitted them to the FHA. Originally it was our intention to build one-family dwellings. While we were in the FHA office, the assistant to the chief architect said, "Here is something new, warehousing, 608, look into this." He gave us some plans.

Q. Do you remember the name of this person?

A. Yes, it was Gerber. I can't remember his first name, but his last name was Gerber.

Q. What did you do?

A. Well, it attracted us. We read the literature and we [fol. 103] showed them some of the land that we were interested in. He said, "Take this, this is good. Start on this. Why don't you file an application?"

Q. Did you organize a sponsoring corporation?

A. We filed an application. We found out that we had to have a sponsoring corporation and a construction corporation. That was the understanding.

Q. Did you organize a sponsoring corporation?

A. Yes.

Q. What was the name of that?

A. 1942.

Q. What was the name?

A. Somerset Homes, Inc.

Q. Where did it build?

A. In Somerville, New Jersey.

Q. I now show you Exhibit 72-TTT, which has been attached to the stipulation of facts.

A. Yes.

Q. If you look at that exhibit, you will see it lists three 608 projects completed in 1943 and 1944 and sold in 1953.

A. Yes.

Q. A fourth 608 project completed at the end of 1947 and sold in 1953, and the fifth 608 project which was completed in 1945 and sold in 1949. When I say "sold", I mean that the stock was sold.

A. Yes.

Q. Did you, your brother Harry and Mr. Braunstein own the stock of these corporations?

A. Three of us did.

Q. Did the three of you own the stock in three equal shares?

A. Yes, sir, we did.

Q. Where were these five projects located?

A. Well, the first four were located in Somerville, New Jersey. The last one was located in Hillside, New Jersey.

Q. Will you identify the one that was in Hillside?

A. Monroe Gardens.

Q. What kind of apartments were they?

A. Garden-type apartments, two-story buildings.

Q. If you will continue to look at the exhibit, it seems to indicate that the stockholdings in Somerset, Somerville, Madison and Brookside were all sold in 1953.

A. That is correct.

Q. Were the stockholdings in each of those corporations sold separately or in one transaction?

A. They were sold as a package deal, the first four items.

Q. Did the stockholders realize any gains on the sale?

A. Yes, we did.

[fol. 104] Q. How did you record the gains on the sale of all five?

A. Capital gain.

Q. Do you know how your brother and Mr. Braunstein recorded those?

A. Same way.

Q. Has that treatment ever been questioned by the Commissioner?

A. No.

Q. Can you tell us why the stock of Monroe Gardens was sold in 1949?

A. We had a very good offer. We decided to take it.

Q. Before you sold Monroe Gardens, were you looking for a purchaser?

A. No.

Q. How was the price computed on the sale of the four Jersey projects that were sold in 1953?

A. It was computed on a basis of about one thousand dollars per apartment.

Q. Is apartment sometimes referred to as a unit?

A. Yes, one thousand dollars per unit.

Q. Did you or the other stockholders seek out the purchaser?

A. No, we did not.

Q. How did the purchaser get to you?

A. They came to us in 1953.

Q. Who were the people who came to you?

A. Kislak's office, Herman Stein and Herman Schorr, came to us.

Q. Where did they come?

A. In our office in Jamaica.

Q. At that time, was there a going market price for such projects?

A. Yes, there was.

Q. What was that going market price?

A. At that time, we understood the price to be about eight hundred dollars per apartment in 1953.

Q. I think you indicated before that you got one thousand dollars per unit?

A. That is right.

Q. Can you explain how you got one thousand dollars when the going rate was about eight hundred?

A. We were one hundred per cent occupied. We had been one hundred per cent occupied since 1943. We had never had a vacant apartment and the buildings were kept up in perfect conditions and for that reason, I believe, the purchasers recognized it.

[fol. 105] Q. Putting aside the Hill and Springfield proj-

ects which are involved immediately in this case, what other properties did you and your associates acquire?

A. During what years?

Q. From World War II until about the end of 1947. Was there any other FHA project?

A. This is exclusive of Hill and Springfield.

Q. Take us past 1947.

A. We started to negotiate for the purchase of property that was used for Mitchell Gardens in Flushing around 1948 and 1949.

Q. What kind of project did you put up in Mitchell Gardens?

A. That was a cooperative project.

Q. Under what section of FHA?

A. Section 213. May I refer to some notes here?

Q. Yes, you may. Will you tell us what other projects or developments you were engaged in putting up aside from Springfield or Hill?

A. Subsequent or prior to 1947?

Q. After World War II up to the present.

A. Well, we built—we acquired land from, land for Mitchell Gardens and built that. We acquired the land for Linden Hill which is also a cooperative project, we built that.

Q. When did you build the cooperative apartment in Linden Hills?

A. 1953 and 1954.

Q. Under what Title?

A. Also Section 213.

Q. Let us stay with Linden Hills for a while. Did you sell any stock in that project for profit?

A. No, sir.

Q. What did your income consist of?

A. Our income consisted in a profit from a construction contract.

Q. In other words, your income received as a builder?

A. Yes.

Q. Was that reported as ordinary income or capital gain?

A. Yes, that was reported as ordinary income.

Q. What other construction were you engaged in?

A. I mentioned Mitchell Gardens. We built some stores—you mean up to the present?

Q. Up to the present. I would like you to tell us pre-
[fol. 106] cisely what you did in Mitchell Gardens.

A. We erected about 1200 apartments for the cooperative corporations.

Q. What did your income consist of?

A. The profits from the construction.

Q. Were those profits reported as ordinary income?

A. Yes, sir, ordinary income.

Q. And to get this clear, when was Mitchell Gardens put up?

A. In 1951 and 1952.

Q. Can you tell us of still other construction?

A. Yes, we acquired some property on Main Street in Flushing, some store property.

Q. When did you do that?

A. That we acquired about 1947; 1947 we still own it.

Q. Did you engage in any construction there?

A. Yes, we remodeled the buildings and put up modern stores.

Q. When did you do that?

A. That was done in 1956.

Q. Can you think of any other building activities?

A. Yes, in 1955, we acquired a tract of land in Flushing and built a large apartment house.

Q. When you say "we", whom do you mean?

A. The J. L. D. Realty in which my brother and Mr. Braunstein and myself were the stockholders.

Q. Does that corporation still own that building?

A. Yes, sir, it does.

Q. How was the construction of that apartment house financed?

A. Conventional financing.

Q. You mean by private mortgage loan?

A. Yes, from a bank.

Q. Are you sure you have told us of all the construction activity you have engaged in?

A. No, we built a shopping center in Mitchell Gardens in 1952.

Q. When you say "we", whom do you mean?

A. My brother and myself and Mr. Braunstein.

Q. Do you own that individually?

A. Yes, we do. We own it as individuals. Then we also

in 1956, adjoining the shopping center, we erected a building for the U. S. Post Office and the upper floor is occupied by the Metropolitan Life Insurance Company.

[fol. 107] Q. When was that building put up?

A. 1956.

Q. Continue.

A. Now, also, Springfield Boulevard in Bayside, we erected a shopping center. That was done in 1948.

Q. When you say "we", whom do you mean?

A. That was done—that was really a contract job for the Oakland Gardens, Inc.

Q. What did your income consist of?

A. There we had no income. It was done on a reimbursement basis.

Q. Does that exhaust all your activities in real estate?

A. No, we have some vacant parcels acquired during those years. We have a vacant parcel on Northern Boulevard at Flushing which we are at the present moment intending to build an apartment house on.

Q. When you say "we have it," who has it?

A. Braunstein, Harry and myself.

Q. As individuals?

A. Right now it is owned as individuals, but it will probably be—

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[fol. 186]

In the Tax Court of the United States

Excerpts From Findings of Fact—April 11, 1961

Some of the facts and a substantial amount of evidence have been stipulated.

Benjamin Braunstein and Diana Braunstein are husband and wife, and residents of Flushing, New York. Benjamin Neisloss and Julia Neisloss were husband and wife and residents of Forest Hills, New York, during the period here pertinent. Harry Neisloss and Lillian Neisloss are husband and wife, and also residents of Forest Hills. The respective husbands and wives filed joint income tax returns for the taxable year 1950 with the collector of internal revenue for the first district of New York. The husbands are sometimes hereafter referred to as the petitioners.

Benjamin and Harry Neisloss were brothers and were active in various real estate enterprises from 1919. During the 1920's they, as individuals or through corporate organizations, built and sold one-family homes on Long Island, engaged in construction work for others, purchased several parcels of land for development, and acquired and improved commercial property which was disposed of in 1929.

During the 1930's the Neisloss brothers organized and operated Benhar Holding Corporation, Lawrence Homes, Inc., and Hillburn Holding Corporation, in which they were equal stockholders. The Benhar Holding Corporation built garden-type apartment homes in 1930 and 1931. The brothers sold their stock in that corporation in 1946. The Lawrence Village Homes, Inc., built and sold about 100 houses between 1936 and 1938, constructed a business building as a contractor, and was liquidated about 1939. The Hillburn Holding Corporation built a row of stores in 1938, and the Neisloss brothers sold their stock in that corporation in 1948.

Benjamin Braunstein is an architect, who met the Neisloss brothers in 1930, when he designed the garden apart- [fol. 187] ments of the Benhar Holding Corporation. In 1938 Braunstein and the Neisloss brothers organized and were equal stockholders of the Henshire Holding Corporation, which erected a large apartment house, sold the property in 1941, and was dissolved. In 1938 they organized Weeks-Woodlands, Inc., which built and sold about 100 houses, reported its profits as ordinary income, and was liquidated after the houses were sold.

Beginning in 1943, the three petitioners organized and were equal stockholde in seven corporations, which constructed multiple dwelling garden-type apartments located in New Jersey and in New York and financed under section 608 of the National Housing Act. After the passage of varying periods of time up to ten years from the dates of completion of these projects, petitioners sold their stock therein. The corporate names of the projects, the years of completion and the years the stock was sold, were as follows:

Project	*Year of Completion*	*Year of Sale of Stock*
Somerset Homes, Inc.	1943	1953
Somerville Gardens, Inc.	1943	1953
Madison Gardens, Inc.	1944	1953
Monroe Gardens, Inc.	1945	1949
Brookside Gardens, Inc.	1948	1953
Springfield Development Co., Inc.	1949	1950
Hill Development Co., Inc.	1949	1950

The sales were solicited by brokers acting on behalf of the buyers. The 1953 sale of stock in the four corporations was in one transaction. The 1950 sale of stock in the two corporations was in one transaction. The petitioners reported their profits on the 1949, 1950 and 1953 sales as capital gains.

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[fol. 249] Penzell and Manoochehrian undertook to sell the contract of June 8, 1950, for the purchase of the Springfield and Hill stock, but were unable to find a purchaser, and at September 8, 1950, the first date specified for closing, they exercised their privilege of postponing the closing until September 18, 1950. On the latter date, they secured another extension to September 30, 1950, by paying an additional $50,000. They were engaged at that time in negotiations with a prospective purchaser, but the sale was not consummated, whereupon Manoochehrian refused to go ahead with the closing. Due to the inability of Penzell to complete the purchase by himself, he was granted a period of several more days within which to act, and on October 5, 1950, the petitioners agreed to a further extension of thirty days.

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[fol. 250] After the sale of the stock of Springfield and Hill to Penzell and his associates, the two corporations provided utilities free to their tenants. Springfield and Hill continued as owners of the two projects.

• • • • • • •

The petitioners each owned more than 10 percent in value of the outstanding stock of Springfield and Hill at

the time they acquired such stock and until the sale thereof on November 13, 1950. On the date of sale, such stock had been held by the petitioners for more than six months. The shares were not held as stock in trade or as property of a kind properly includible in inventory, nor were they property held primarily for sale to customers in the ordinary course of any trade or business.

After the sale of the Springfield and Hill stock, the petitioners continued to be active in real estate and the construction of projects, including apartment houses, stores and a building for the Post Office Department.

* * * * * * * *

[fol. 253] The distributions made by Springfield and Hill to petitioners, their shareholders, and the sale by the petitioners of their Springfield and Hill stock were attributable to circumstances which had been advisedly created by the petitioners and which were present prior to the completion of the two projects and to circumstances which reasonably could be anticipated at the time of construction, and were not attributable solely to circumstances which arose after the time of construction.

* * * * * * * *

[fol. 281]

TAX COURT OF THE UNITED STATES

Washington

Docket No. 56657

BENJAMIN BRAUNSTEIN AND DIANA BRAUNSTEIN, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

DECISION—April 25, 1961

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion filed April 11, 1961, it is

ORDERED AND DECIDED: That there is a deficiency in income tax for the taxable year 1950 in the amount of $181,248.06.

Entered April 25, 1961

Bolon B. Turner, Judge.

[fol. 282]

TAX COURT OF THE UNITED STATES

Washington

Docket No. 56658

ESTATE OF BENJAMIN NEISLOSS, Deceased, JULIA H. NEISLOSS AND RUSSELL NEISLOSS, Executors, and JULIA NEISLOSS, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

DECISION—April 25, 1961

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion filed April 11, 1961, it is

ORDERED AND DECIDED: That there is a deficiency in income tax for the taxable year 1950 in the amount of $156,707.14.

Entered April 25, 1961

Bolon B. Turner, Judge.

TAX COURT OF THE UNITED STATES

Washington

Docket No. 56659

HARRY NEISLOSS AND LILLIAN NEISLOSS, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

DECISION—April 25, 1961

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion filed April 11, 1961, it is

ORDERED AND DECIDED: That there is a deficiency in income tax for the taxable year 1950 in the amount of $158,165.48.

Entered April 25, 1961

Bolon B. Turner, Judge.

[fol. 320]

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 256-7-8—September Term, 1961.

(Argued May 22, 1962)

Docket Nos. 27146-7-8

BENJAMIN BRAUNSTEIN and DIANA BRAUNSTEIN; Estate of BENJAMIN NEISLOSS, Deceased, JULIA NEISLOSS and RUSSELL NEISLOSS, Executors and JULIA NEISLOSS; HARRY NEISLOSS and LILLIAN NEISLOSS, Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE, Respondent.

OPINION—July 6, 1962

Before: Lumbard, Chief Judge, Smith and Marshall, Circuit Judges.

Petition to review a decision of the Tax Court of the United States, Turner, *Judge*, holding that two corporations were collapsible corporations under §117(m) of the Internal Revenue Code of 1939 and thus their shareholders recognized ordinary income on the sale of the stock of the corporations and the receipt of distributions from the corporations. 36 T. C. 22 (1961).

Affirmed.

[fol. 321] Thurman Arnold and Louis Eisenstein, Washington, D. C. (Julius M. Greisman and Arnold, Fortas & Porter, Washington, D. C., on the brief), for petitioners.

David O. Walter, Department of Justice, Washington, D. C. (Louis F. Oberdorfer, Assistant Attorney General, Lee A. Jackson and Harry Baum, Department of Justice, on the brief), for respondent.

LUMBARD, Chief Judge:

The taxpayers,[1] who had previously been active in constructing homes and apartment buildings, formed two corporations in 1948 for the purpose of building apartment houses in a development called Oakland Gardens in Bayside, Queens County, New York, to be financed under §608 of the National Housing Act.[2] The Federal Housing Administration (FHA) guaranteed mortgage loans to the two corporations which then built the proposed projects. Each corporation had an excess of mortgage loan funds remaining after the costs of construction had been paid. In 1950, the year following completion of construction, the three taxpayers sold their stock in both corporations at a profit and, as part of the sale transaction, received distributions which included the excess mortgage funds from the two corporations. The taxpayers reported the excess of the [fol. 322] amounts they received—both on the distributions from the corporations and on sale of their stock—over their bases in the stock and the expenses of sale as long-term capital gains of $313,854.17 each. The Commissioner asserted that the two corporations were collapsible corporations under §117(m) of the Internal Revenue Code of 1939[3]

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[1] Diana Braunstein, Julia Neisloss, and Lillian Neisloss are included in this proceeding only because they filed joint returns with their husbands, Benjamin Braunstein, Benjamin Neisloss and Harry Neisloss, repectively. The three husbands will herein be referred to as the taxpayers. Benjamin Neisloss is now deceased, his estate having been substituted as a party herein.

[2] The taxpayers formed two corporations rather than one because §608(b)(3) of the National Housing Act, 12 U. S. C. §1743(b)(3), prohibits loans beyond $5,000,000 to any one mortgagor.

[3] §117(m)—

"(1) Treatment of gain to shareholders.—Gain from the sale or exchange (whether in liquidation or otherwise) of

[fol. 323] so that the gains from the distributions and from the sale of the stock were ordinary income. In a decision which was reviewed by the full court, the Tax Court up-

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stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

"(2) Definitions.—

"(A) For the purpose of this subsection, the term, 'collapsible corporation' means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

"(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

"(ii) the realization by such shareholders of gain attributable to such property.

* * * * * * *

"(3) Limitations on application of subsection.—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

"(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

"(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; and

"(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production. * * *"

[As added by §212(a) of the Revenue Act of 1950, c. 994, 64 Stat. 906.]

held the Commissioner with one judge dissenting. 36 T. C. 22 (1961). The taxpayers appeal, and we affirm.

The Taxpayers Had the Requisite View During Construction

According to §117(m)(1) of the 1939 Code, gain from the sale or exchange of stock of a "collapsible corporation," which gain, but for §117(m), would be long-term capital gain, is ordinary income. According to §117(m)(2)(A), a corporation is a "collapsible corporation" if it is formed or availed of principally for the construction of property "with a view to * * * the sale or exchange of stock by its shareholders * * * or a distribution to its shareholders, prior to the realization by the corporation * * * constructing * * * the property of a substantial part of the net income to be derived from such property" and "with a view to * * * the realization by such shareholders of gain attributable to such property." This "view" is present "whether such action [sale or exchange of the stock or distribution to shareholders] was contemplated unconditionally, conditionally, or as a recognized possibility." Treas. Reg. 111, §29.117-11(b) (1953). The "view" to such sale or distribution must exist at some time "during construction." Treas. Reg. 111, §29.117-11(b) (1953). See *Jacobson* v. *Commissioner*, 281 F. 2d 703 (3 Cir. 1960). But see *Glickman* v. *Commissioner*, 256 F. 2d 108, 110-11 (2 Cir. 1958) (dictum). Thus if "the sale, exchange, or distribution is attributable to circum- [fol. 324] stances present at the time of * * * construction * * * the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of." Treas. Reg. 111, §29.117-11(b) (1953). The regulations state that when a corporation's construction of property is substantial in relation to its other activities and its shareholders sell their stock or receive a distribution, thus recognizing a gain before the corporation has realized a substantial part of the net income from the property, these facts will ordinarily be sufficient, in the absence of other facts, to establish that the corporation is collapsible. Treas. Reg. 111, §29.117-11(d) (1953).

In an attempt to satisfy their burden of proof that they did not have the requisite view to sale or distribution during construction the taxpayers make two main arguments. They contend that they intended the two corporations to be repositories for the accumulation of substantial estates for their families, and thus meant the corporations to be long-term investments. They further contend that the distributions and sales were attributable to an unanticipated decline in the profitability of the two corporations—a decrease in rent income and an increase in expenses—which occurred after construction was completed. The Tax Court found that although the taxpayers may have been attempting to make profits, the facts were inconsistent with the use of the two corporations as a repository for these profits. The Tax Court also found that the facts did not bear out the taxpayers' claims that there was an unexpected decline in profitability after the completion of construction. We conclude that the Tax Court was not wrong when it found that the taxpayers had the requisite "view" prior to the completion of the two projects.[4]

[fol. 325] Although Benjamin Neisloss testified that the two corporations were intended as a long-term repository for the accumulation of a large estate, the Tax Court need not accept the unsupported testimony of an interested party. See, e.g., *Hartman* v. *Commissioner,* 296 F. 2d 726, 727-28 (2 Cir. 1961); *Payne* v. *Commissioner,* 268 F. 2d 617, 621 (5 Cir. 1959); *Cohen* v. *Commissioner,* 148 F. 2d 336 (2 Cir. 1945). Thus it is necessary for us to examine the facts to see if they lend support to the taxpayers' contention.

Benjamin and Harry Neisloss were brothers active in various real estate construction enterprises since 1919. Benjamin Braunstein is an architect who had been associated with the other two since about 1930. Beginning in 1943 the three taxpayers organized and were equal stockholders in seven corporations which constructed multiple dwelling garden-type apartments financed under §608 of the National Housing Act. After the passage of between

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[4] Although Judge Kern, the only judge to hear the oral testimony, dissented, the weight of the Tax Court's findings is not lessened because, as Judge Kern recognized, few of "the evidentiary facts are themselves in dispute," 36 TC at 88.

one and ten years from the completion of these projects, the taxpayers sold their stock in the seven corporations in 1949, 1950, and 1953. This case concerns the distribution of cash and the sale of the stock of two of these corporations.

On March 31, 1948 Springfield Development Company, Inc., and Hill Development Company, Inc., were incorporated. Each of the three taxpayers purchased ten shares of the common A stock of each corporation for $1 per share. The FHA purchased 100 shares of each corporation's preferred stock for $1 per share. Thus the two corporations' total paid-in capital was only $260. The taxpayers and their other corporations made loans to Springfield and Hill which were repaid out of the mortgage loan proceeds. Although such a nominal capitalization is not wholly incon- [fol. 326] sistent with the taxpayers' claims that they intended Springfield and Hill as a repository for the accumulation of their estates, it certainly does not lend weight to their contentions.

Previously the taxpayers had obtained a commitment from the FHA for mortgage loan insurance for the two projects, which were in fact parts of a single overall development. The FHA's total estimated cost of the projects was $6,845,804 and the total mortgage insurance commitments were $6,101,600. Both corporations entered into loan agreements with the Bank of Manhattan Company to advance the amount of the FHA mortgage insurance commitment with 4% interest.

Springfield and Hill entered into contracts with the N. B. Construction Company, Inc., of which the three taxpayers were equal shareholders, for the construction of the projects.[3] Although these contracts specified a lump sum consideration, in practice Springfield and Hill merely reimbursed N. B. Construction for its costs.

Construction was begun in April 1948 and the various buildings were completed between September 1948 and June 1949. The costs of construction were less than had been

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[3] This corporation was later succeeded by N. B. Construction Company, a partnership consisting of the three taxpayers, which completed the work. The corporation and partnership are regarded as interchangeable for purposes of this opinion.

estimated. Instead of contracting out the carpentry and plumbing work, the taxpayers had their own men do the work, saving $80,000 on carpentry and $85,000 on plumbing and heating. A decline in the cost of lumber resulted in a saving of $50,000. There were other savings amounting to nearly $90,000 in title and recording expenses and legal and organizational expenses. Furthermore, the FHA cost estimates had included $599,741 as the total builder's and architect's fees to be incurred by Springfield and Hill. N. B. [fol. 327] Construction acted as builder (in addition to doing the construction work) and Benjamin Braunstein acted as architect for the two corporations without pay,[6] thus saving nearly $600,000 more.

Thus the mortgage loan proceeds exceeded the cash expenditures in constructing the two projects by more than $150,000. These excess funds were not used to prepay a part of the corporations' large mortgage indebtedness which was costing them 4% interest. Rather, these funds were loaned interest free to the taxpayers' other construction projects. Therefore, Springfield and Hill, far from accumulating the taxpayers' estate, were incurring uncompensated interest expenses while taxpayers' other corporations used the money to make a profit.

The land on which these projects were built was not owned by Springfield and Hill. In April and May 1947 Benjamin Neisloss entered into contracts to purchase the land for $120,000. On December 15, 1947, this land was conveyed to the wives of the three taxpayers who leased it to Springfield and Hill for 99 years at a total annual rental of $23,824, a rate which would repay the original cost in five years. In the FHA project analysis it was estimated that this land would be worth $595,600, five times its purchase price, after the projects were built. Although the legality or the propriety of this transaction is not questioned, it is evident that burdening the corporations with a substantial long-term rent obligation and shifting the benefit of the increase in value of the land due to the construction thereon

[6] Both of their contracts called for payment of fees in Common B stock. But shortly after entering these contracts both N. B. Construction and Braunstein released Springfield and Hill from their obligations to transfer the Common B stock.

from the corporations to the taxpayers' wives are not consistent with the taxpayers' claimed purpose to make Spring-[fol. 328] field and Hill long-term repositories of their increased estates.

These facts—nominal capitalization, interest free loans, and ownership of the land by the taxpayers' wives—while not necessarily inconsistent with Neisloss' testimony that the taxpayers intended to hold Springfield and Hill as long-term investments, lend little support to it. We turn now to the taxpayers' other contention, that the decision to sell was due solely to circumstances arising after construction which could not reasonably have been anticipated at the time of construction.

In making application for mortgage loan insurance the taxpayers submitted estimates of Springfield's and Hill's annual income and expenses. The FHA in making a project analysis made their own estimates. Rather than computing projected net income, the taxpayers and the FHA estimated net cash inflow, i.e., they started with estimated rent income and then deducted estimated cash expenses, estimated payments to the reserve for replacement of refrigerators, stoves, and equipment to be held by the mortgagee, and the amount of annual debt service (interest and principal payments and the cost of mortgage insurance), thus arriving at "Cash available for income taxes, corporate taxes, dividends and surplus." The estimates were as follows:

	FHA Estimate	*Taxpayers' Estimate*
Springfield	\$53,925	\$28,361
Hill	24,916	16,631
Total	\$78,841	\$44,992

The Tax Court found that in entering into the project the taxpayers were relying upon their own estimates and not on the FHA's higher predictions.

[fol. 329] The taxpayers claim that decreases in rental income which were not expected when construction was completed and increases in operating expenses which were also unanticipated reduced the cash available for taxes, dividends and surplus to a deficit of \$20,000 per year, and that

the projects, far from being self-liquidating, would then have required the taxpayers to make annual contributions to the corporations' capital. This unexpected turn of events, rather than a previously held view to sale, the taxpayers argue, prompted them to decide to sell in late May 1950. The taxpayers compute the $20,000 annual deficit as follows:

FHA's estimated annual cash surplus	$78,841
Less: Increased real estate taxes	$30,000
Cost of garbage and rubbish removal	10,000
Cost of furnishing free gas and electricity to tenants	31,000
Decline in rental income	16,000
Increased costs of redecorating	10,000
	$97,000
Cash deficit	$18,159

After examining all these factors which the taxpayers allege contributed to the purported cash deficit of nearly [fol. 330] $20,000, we find that there was in fact no cash deficit and that the project, although not doing quite as well as the taxpayers had predicted, was earning a cash surplus. It is necessary to examine each of the factors which purportedly contributed to this nearly $20,000 annual cash deficit.

During early 1950 the New York newspapers predicted a large real estate tax increase. When the rate on Springfield's and Hill's property was fixed in June 1950 these predictions proved true. The FHA's and the taxpayers' estimates of real estate taxes and the actual 1950-51 tax in total for Springfield and Hill are as follows:

FHA's Estimates	$133,668
Taxpayers' Estimate	168,617
Actual 1950-51 real estate tax	163,663

The taxpayers, in calculating their $20,000 annual cash deficit, rely upon the fact that actual real estate taxes exceeded the FHA's estimate by $30,000. However, since the actual tax fell $5,000 short of the taxpayers' own estimate, they cannot claim that the amount of the real estate taxes was an unexpected factor.

In April 1949 the City of New York discontinued its service of garbage and rubbish removal.[9] Thus the projects were forced to procure this service from a private contractor at a cost of approximately $8,500 a year which had not been anticipated at the time the estimates were made. The government argues that since the taxpayers were aware of this expense just before construction was completed in June 1949, to the extent that it produced a view to sell, this view was held "during construction." See *Glickman* v. *Commissioner*, 256 F. 2d 108, 111 (2 Cir. 1958). However, it has been argued that if a view to sell first [fol. 331] arose after all the decisions affecting construction had been made and construction was largely completed, the view did not arise early enough to make the corporation collapsible. McLean, Collapsible Corporations—The Statute and Regulations, 67 Harv. L. Rev. 55, 61-62 (1953). Even accepting *arguendo* the latter position, we think that the Tax Court was correct. Thus we assume that this expense of $8,500 per year arose after construction was sufficiently near completion.

Springfield and Hill had not intended to provide free gas and electricity to their tenants. However, since various competing projects did provide free utilities, Springfield and Hill had difficulty attracting and retaining tenants. Thus, by May 1950 the taxpayers decided that Springfield and Hill would have to meet competition and furnish free utilities. The cost of such a step was estimated at $31,000 per year. It appears that this expense was unexpected and might have reduced the projects' profitability unless

the rents were increased slightly. Although the Federal Housing Regulations did not permit the taxpayers to increase rents without the district director's approval, Neisloss testified that the FHA entertained applications for increases if actual operating costs exceed the estimates. Of course, the competitive situation might have prevented an increase in rents and to that extent the cost of utilities would have reduced the net cash income.

The taxpayers also claim that the vacancy rates exceeded the 7% vacancies used by the FHA and the taxpayers in making their estimates. However, during the period in question, the first half of 1950, the taxpayers had not yet begun to supply free utilities. Since Springfield's and Hill's failure to meet competition during these months was probably a major cause of their high vacancy rate and since the taxpayers had decided to supply free utilities, [fol. 332] the loss of revenues from excessive vacancies must be disregarded in predicting the projects' future net cash income. Similarly, once Springfield and Hill met competition the turnover of tenants would be reduced and the claimed redecorating costs *pro tanto* reduced. Thus the increased decorating costs and reduced rental income cannot be considered cumulatively with the cost of gas and electricity, but should be considered alternatively.

Taking the unexpected cost of utilities and garbage removal into account, the project would still have been expected to produce an annual cash surplus. The two corporations' actual results for the period before and after May 1950 bear out this conclusion. Before construction had begun the taxpayers estimated that Springfield's annual cash surplus would be $28,361 and Hill's $16,631. The projects' actual cash surplus was as follows:[7]

[7] These figures were obtained by taking each corporations' net loss as reported on its federal income tax return, adding back non-cash depreciation expense and interest and insurance on the mortgage, and then subtracting the FHA's estimated annual payments for debt service (including interest and principal and mortgage insurance) and the annual payments to the reserve for replacement of equipment.

	1950	1951
Springfield (Year ended Aug. 31)	$85,133	$27,351
Hill (Year ended Jan. 1)	8,978	11,596

It is difficult to believe that this small decrease, which is all the taxpayers had cause to expect, would have caused experienced real estate operators like the three taxpayers to sell their stock unless they had a previous view to its sale. Were the courts to permit any minor adversity to serve as the pretext for a previously con- [fol. 333] templated disposition, the collapsible corporation provision would indeed have a narrow scope. Thus, we must distinguish between those events which truly motivate a change in existing plans and those which merely operate as a trigger.

The taxpayers argue that this analysis is altogether too objective since the question in issue is whether the taxpayers subjectively had a view to sell during construction. However, only by determining the objective facts and attempting to ascertain their effect on the taxpayers' minds can the court assess Benjamin Neisloss' self-serving testimony that the taxpayers had no view to sell until after construction had been completed.[8]

In late May 1950 the taxpayers were approached by brokers on behalf of prospective purchasers, and in early June a contract was signed setting the price for all of Springfield's and Hill's stock at $400,000 subject to various plus and minus adjustments. Since the purchasers did not want to pay for a large amount of cash held by the corporations, Springfield and Hill increased the book value of its assets and declared dividends to the taxpayers totalling $555,000.[9] Since neither Springfield nor Hill had

[8] McLean, Collapsible Corporations—The Statute and Regulations, 67 Harv. L. Rev. 55, 65-66 (1953); DeWind & Anthoine, Collapsible Corporations, 56 Colum. L. Rev. 475, 483 (1956).

[9] Since Springfield and Hill had loaned most of their excess cash to taxpayers' other enterprises, part of the $555,000 distribution was made by a set of bookkeeping entries rather than through an actual cash distribution.

any accumulated earnings and profits at the time of the distribution or any earnings and profits for its taxable year in which the distributions were made, the distributions were not dividends for income tax purposes. Internal [fol. 334] Revenue Code of 1939, §115(a).[10] The final sale price of all the stock was $399,702. Taxpayers reported a total long-term capital gain on their 1950 income tax returns as follows:

Distributions from Springfield and Hill	$555,000
Selling price of Springfield and Hill stock	399,702
	$954,702
Less	
Cost of stock	$ 60
Expenses of sale	13,079
	$ 13,139
Gain	$941,563

Since we do not think that the Tax Court was wrong in concluding that the taxpayers had the requisite view to sale during construction, this gain is ordinary income unless for some other reason the collapsible corporation provision does not apply.

[10] Section 312(j) of the 1954 Code, applicable to distributions made after June 22, 1954, would have caused these distributions to be treated as dividends by increasing the corporations' earnings and profits by the amount of the excess of the FHA guaranteed loans over the adjusted basis of the buildings. However, under the 1939 Code, unless the collapsible corporation provision applies, the distributions would be treated as capital gains to the extent that they exceed the shareholder's basis. 1939 Code, §115(d); *Commissioner* v. *Gross*, 236 F. 2d 612 (2 Cir. 1956), aff'g. 23 TC 756 (1955).

[fol. 335] *More than 70% of the Gain Was Attributable to the Constructed Property*

Section 117(m) does not apply to this gain "unless more than 70 per centum of such gain is attributable to the property so * * * constructed." 1939 Code §117(m)(3)(B). The taxpayers claim that more than 30% of the gain is due to detained rental income and that such gain is not "attributable to the property so * * * constructed." Since we find that less than 30% of the gain was due to retained income, we need not decide whether the regulations which broadly interpret "gain attributable to the property," apparently to include gain attributable to retained rental income, Treas. Reg. 111, §29.117-11(c)(3), are valid. Compare *Spangler* v. *Commissioner*, 278 F. 2d 665, 670-71 (4 Cir. 1960), cert. denied, 364 U. S. 825 (1960); *Bryan* v. *Commissioner*, 281 F. 2d 238, 241 (4 Cir. 1960), cert. denied, 364 U. S. 931 (1961) (upholding the regulation), with McLean, *supra* note 8, at 79-80; DeWind & Anthoine, *supra* note 8, at 516; Anthoine, Recent Developments in Collapsible Corporations, New York University 14th Annual Institute on Federal Taxation 761, 782 (1956) (rejecting the regulation).

Springfield and Hill reported net losses on their income tax returns for the period that the taxpayers held their stock. However, in computing the amount of rental income that the two corporations accumulated, the taxpayers ask us to exclude two classes of deductions taken by the corporations on their income tax returns. But even if we agree with them as to the first, depreciation, which is a non-cash expense, the taxpayers' argument falls short. The monthly payments to the mortgagee for replacement of equipment should then be regarded as coming out of operating revenues. The replacement of existing equipment is a prerequisite to continued operations. Therefore, we reject the [fol. 336] taxpayers' claim that payments to the reserve for replacement should be treated as coming pro-rata from the excess mortgage proceeds and the accumulated rental income. And we disagree with the taxpayers as to the second, interest and real estate taxes incurred during construction. Since the corporations chose to deduct these expenses on

their income tax returns, we regard them as having been made out of operating income rather than out of the excess mortgage proceeds as the taxpayers argue. Consequently, less than 30% of the gain was due to accumulated operating income.

Section 117(m) Applies Even if Sale of the Corporate Assets Would Have Produced Capital Gain Had No Corporation Existed

The taxpayers' final argument is that §117(m) should not apply if the constructed apartment buildings would have produced capital gain on a sale by the taxpayers had no corporation been formed. We reject this argument which has, however, been recently accepted by the Fifth Circuit in *United States* v. *Ivey*, 294 F. 2d 799 (5 Cir. 1961) (2-1), rehearing denied with opinion, — F. 2d — (1962) (2-1).[11] The argument goes as follows:

If a taxpayer who is engaged in a trade or business constructs an asset which he holds primarily for sale in the ordinary course of his trade or business, any gain from the sale of the asset is ordinary income. 1939 Code §117 (a)(1)(A), (j)(1). Before the collapsible corporation provision was passed, a taxpayer could have formed a corporation to construct the asset and upon sale of the corporation's stock recognized capital gain instead of the ordinary [fol. 337] income he would have received had no corporation been used. Therefore, the taxpayer argues, the collapsible corporation provision was enacted to give the taxpayer ordinary income on the sale of the stock just as he would have had ordinary income on the sale of the asset, and if the taxpayer, had he constructed and sold the asset himself, would not have had ordinary income on its sale, the collapsible corporation provision should not apply.

The collapsible corporation provision as literally written applies regardless of whether the assets constructed by the corporation would have produced capital gain or ordi-

[11] See also *Honaker Drilling, Inc.* v. *Koehler*, 190 F. Supp. 287 (D. Kan. 1960), where the district court utilized this argument to find that the corporation was not availed of with the requisite view.

nary income if constructed and sold by the shareholder. Although this occasionally produces unwarranted taxation of capital gains as ordinary income, for the courts to rewrite the very complex legislation embodied in §117(m) of the 1939 Code and its successor, §341 of the 1954 Code, would produce even more confusion.[12]

The taxpayers in this case and the Fifth Circuit in *Ivey* assume that the sole purpose of the collapsible corporation provision was to deal with those cases where the shareholder would have had ordinary income if he had sold the assets himself. However, the legislative history discloses that §117(m) has another major purpose. H. R. Rep. No. 2319, 81st Cong., 2d Sess. 56-57, 97 (1950); Sen. Rep. No. 2375, 81st Cong., 2d Sess. 45, 89 (1950); H. R. Rep. No. 586, 82nd Cong., 1st Sess. 25 (1951); Sen. Rep. No. 781, 82nd Cong., 1st Sess. 33 (1951). See also DeWind & Anthoine, *supra* note 8, at 475-77 (1956); Note, Legislative Response [fol. 338] to the Collapsible Corporation, 51 Colum. L. Rev. 361-62 (1951); Bittker, *supra* note 12, at 299-300. If an individual made a movie or constructed an apartment building, income received from the rental of the movie or building would be ordinary income. Thus some taxpayers formed a corporation to make the movie or construct the apartment building and then liquidated the corporation after the movie or the building was finished. On liquidation the shareholders were taxed at capital gain rates on the difference between their basis in the stock and the fair market value of the movie or apartment building, but the shareholders' basis in the movie or apartment building was stepped-up to fair market value. The shareholders could then rent out the movie or apartment building and amortize or depreciate their stepped-up basis against rental income. Congress

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[12] The commentators have generally assumed that the collapsible corporation section would be literally interpreted by the courts. See, e.g., DeWind & Anthoine, *supra* note 8, at 487, 508-09, 533; Anthoine, Collapsible Corporations; 1957 Developments, New York Univ. 16th Annual Institute on Federal Taxation 659, 661 (1958); 3B Mertens, Federal Income Taxation §22.64, p. 271; Mertens, Federal Income Taxation, Code Commentary, §341(b)(3): 1; Bittker, Federal Income Taxation of Corporations and Shareholders 309-10 (1959).

enacted §117(m) to make the shareholders' gain on liquidation ordinary income rather than capital gain. If an individual had made a movie with the intention of renting it, he would have capital gain on a subsequent sale since it would not have been held primarily for sale to customers in the ordinary course of his trade or business. Therefore, the collapsible corporation provision was intended to apply to some cases when the asset if sold by the taxpayer would have produced capital gain. However, if the *Ivey* decison is applied where a movie is made by a corporation which is then dissolved, the collapsible corporation provision will have no application to the basic fact situations which prompted its enactment.

Of course, this difficulty could be remedied by interpreting the *Ivey* decision as applicable only to sales of stock and not to liquidations. Thus, when the stock of a corporation is sold, it would not be collapsible if the underlying assets would have produced capital gain had no corporation been used, but when a corporation is liquidated, it would be [fol. 339] collapsible regardless of whether the underlying assets would have produced capital gain had no corporation been formed. However, since Congress chose to use a single statute to deal with both types of cases, it seems unwise for the courts to create the additional complexities inherent in such a two-fold interpretation. In 1958 Congress, in fact, adopted slightly different tests for collapsibility on liquidation and on sale of stock. Compare 1954 Code §341(e)(1), with 1954 Code §341(e)(2), (4). See Sen. Rep. No. 1983, 85th Cong., 2d Sess. 33-34 (1958). The multiplicity of detailed rules which this duel statutory test necessitated make it manifest that such an approach should not be effected by judicial decision.

Moreover, even as applied to the sale of stock situation, the *Ivey* decision departs from the Code's consistent framework for taxing collapsible corporations. According to the opinion denying a rehearing in *Ivey*, —— F. 2d —— (1962), if all the literal requirements of §117(m) of the 1939 Code or its successor, §341 of the 1954 Code, are satisfied, the court should disregard the shareholders' holding period for their stock and treat the shareholders as if they had owned the corporation's assets directly. Thus, any assets which

the corporation has acquired within six months and which would be capital assets in the shareholders' hands will produce short-term capital gain while those held longer than six months will produce long-term capital gain. Regardless of the theoretical wisdom of this approach, it has no basis in the collapsible corporation provision which Congress has enacted. One of the clear policy decisions embodied in §117(m) and its successor is the treatment of all or none of the gain as long-term capital gain, i.e., the refusal to split the gain between long-term capital gain and ordinary income. See Cohen, Tarleau, Surrey & Warren, A Pro-[fol. 340] posed Revision of the Federal Income Tax Treatment of the Sale of a Business Enterprise—American Law Institute Draft, 54 Colum. L. Rev. 157, 173-74, 177 (1954); *Commissioner v. Kelley*, 293 F. 2d 904, 912-13 (5 Cir. 1961).

Furthermore, regardless of how compatible with the statute the *Ivey* interpretation may have been previous to 1958, the addition of §341(e) in that year makes *Ivey's* interpretation of the collapsible corporation provision anomalous. Although §341(e) did not completely eliminate the conversion of capital gain into ordinary income by the collapsible corporation provision, it was designed to narrow the imposition of ordinary income treatment in an *Ivey* type of case where the shareholder would have recognized capital gain had he constructed and sold the asset without the use of a corporation. Sen. Rep. No. 1983, 85th Cong., 2d Sess. 31-32 (1958); Bittker, *supra* note 12, at 310-313-14. However, *Ivey* went further than §341(e) in narrowing the scope of the collapsible corporation provision.[13] Therefore, if *Ivey* is correct, either §341(e) is unnecessary or, if it is regarded as overruling *Ivey*, it expands rather than contracts the application of the collapsible corporation provision, clearly the contrary of what Congress intended. See Sen. Rep. No. 1983, 85th Cong., 2d Sess. 31-32 (1958).

Although the courts must often interpret sections of the Internal Revenue Code in light of their purposes in order

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[13] Section 431(e) was not applicable in *Ivey* since the operative facts had taken place before its enactment. Although §341(e) had been enacted before the Fifth Circuit decided *Ivey*, the court did not discuss the statutory amendment.

to carry out Congressional intent, see, e.g., *Corn Products Refining Co.* v. *Commissioner,* 350 U. S. 46, 52, 53-54 (1955); [fol. 341] *Gregory* v. *Commissioner,* 293 U. S. 465 (1935), when this would require the courts to extensively rewrite clear statutory language, the task of revision should be left to Congress, see, e.g., *Hanover Bank* v. *Commissioner,* — U. S. — (1962).

Affirmed.

[fol. 342]

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

BENJAMIN BRAUNSTEIN and DIANA BRAUNSTEIN, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

JUDGMENT—July 6, 1962

Appeals from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

On Consideration Whereof it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. Daniel Fusaro, Clerk, By Vincent A. Carlin, Chief Deputy Clerk.

[fol. 344]

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

Estate of BENJAMIN NEISLOSS, Deceased, JULIA H. NEISLOSS and RUSSEL NEISLOSS, Executors, and JULIA NEISLOSS, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

JUDGMENT—July 6, 1962

Appeals from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. Daniel Fusaro, Clerk, By Vincent A. Carlin, Chief Deputy Clerk.

[fol. 346]

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

HARRY NEISLOSS and LILLIAN NEISLOSS, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

JUDGMENT—July 6, 1962

Appeals from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. Daniel Fusaro, Clerk, By Vincent A. Carlin, Chief Deputy Clerk.

[fol. 348] Clerk's Certificate (omitted in printing).

[fol. 349]

SUPREME COURT OF THE UNITED STATES

No. 476—October Term, 1962

BENJAMIN BRAUNSTEIN, *et al.*, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ORDER ALLOWING CERTIORARI—Filed December 10, 1962

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted limited to the following question:

"1. Whether Section 117(m) of the Internal Revenue Code of 1939, which provides that gain 'from the sale or exchange * * * of stock of a collapsible corporation' is taxable as ordinary income rather than capital gain, is inapplicable in circumstances where the stockholders would have been entitled to capital-gains treatment had they conducted the enterprise in their individual capacities without utilizing a corporation."

The case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 476

BENJAMIN BRAUNSTEIN and DIANA BRAUNSTEIN; Estate of Benjamin Neisloss, Deceased, JULIA NEISLOSS and RUSSELL NEISLOSS, Executors, and JULIA NEISLOSS; HARRY NEISLOSS and LILLIAN NEISLOSS, *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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CITATIONS

IN THE

Supreme Court of the United States

October Term, 1962

No.

Benjamin Braunstein and Diana Braunstein; Estate of Benjamin Neisloss, Deceased, Julia Neisloss and Russell Neisloss, Executors, and Julia Neisloss; Harry Neisloss and Lillian Neisloss, *Petitioners,*

v.

Commissioner of Internal Revenue, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgments of the United States Court of Appeals for the Second Circuit.

OPINIONS BELOW

The opinion of the Tax Court (R. 253-280), Judge Kern dissenting (R. 280-281), is reported in 36 T.C. 22 (1961). The opinion of the Court of Appeals (Appendix A, *infra*, pp. 1a-19a) is not yet reported.

JURISDICTION

The judgments of the Court of Appeals (Appendix A, *infra*, pp. 20a-22a) were entered on July 6, 1962. The jurisdiction of this Court is invoked under 28 U.S.C., § 1254(1).

QUESTION PRESENTED

Three individuals were equal shareholders in two corporations which constructed and operated an apartment house development. During the taxable year involved the individuals sold their stock in the corporations. As part of the sale transaction, they also received distributions from the corporations. The question is whether the gains realized on the sale and distributions are taxable as ordinary income, rather than as capital gains, under section 117(m) of the Internal Revenue Code of 1939, relating to collapsible corporations.

STATUTES INVOLVED

The pertinent statutes appear in Appendix B, *infra*, pp. 23a-25a.

STATEMENT OF THE CASE

Benjamin Braunstein, Benjamin Neisloss and Harry Neisloss are hereinafter referred to as the taxpayers.[1] For about 20 years they were jointly engaged in building various apartment houses and commercial properties. Each project was owned through a corporation and held as a long-term investment. The stock in two of the corporations was held for 10 years and

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[1] Diana Braunstein, Julia Neisloss and Lillian Neisloss are parties because they filed joint returns with their husbands. Benjamin Neisloss died on February 4, 1960 (R. 185), and his estate was duly substituted as a party.

15 years before it was sold. A third corporation realized a gain after three years. (R. 49, 78, 99-101, 103, 186-187.) Between 1943 and 1948 the taxpayers organized five corporations which built multiple dwelling projects financed under section 608 of the National Housing Act. The last of the five was completed on January 1, 1948. (R. 49, 78, 103, 187.) The taxpayers held their stock in one for over five years; in one for over nine years; and in two for about ten years. (R. 49, 78, 104, 187.) The taxpayers at no time held any of their numerous investment properties for a quick profit. (R. 49, 78, 99-101, 103, 186-187.) See also pp. 6-7, *infra*.

This case involves another FHA rental development known as Oakland Gardens. The taxpayers organized two corporations—Springfield Development Co., Inc. and Hill Development Co., Inc.—to build and operate Oakland Gardens. (R. 147, 189-190, 199, 215.)[2] The apartments became ready for occupancy from September, 1948 on, and the development was fully completed by July, 1949. (R. 45-46, 61, 67, 207, 220.)

During the period of construction and afterwards, there appeared to be a tremendous demand for apartments. The taxpayers' other FHA projects were fully rented, and they expected the same in Oakland Gardens. (R. 125, 163, 164.) In 1949, after construction was completed, the taxpayers could have sold Oakland Gardens for a quick profit which would have been taxable as a capital gain. (R. 127-128.) Section 117(m) was enacted on September 23, 1950. It was first recom-

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[2] Two corporations had to be formed, rather than one, because section 608(b)(3) of the National Housing Act, 12 U.S.C. § 1743 (b)(3)(1952), barred loans beyond $5 million to any one mortgagor. Here the loans totalled over $6 million. (R. 326.)

mended to Congress on January 23, 1950. See Hearings before the Committee on Ways and Means on Revenue Revision of 1950, 81st Cong., 2d Sess. 2-7 (1950).

Benjamin Neisloss, the managing partner, testified that throughout construction and for about ten months thereafter, the taxpayers intended to hold the property for long-term investment. (R. 125, 127-128.) He was corroborated not only by the 20-year history of the taxpayers' joint enterprises, but also by the facts that: (1) They never listed their stock with brokers; and (2) they flatly refused to consider any offers to buy their stock. One offer was made in March, 1950—about eight months after the project was completed. (R. 127-128, 169) Finally, Neisloss was further corroborated by the fact that the decision to sell was made only after it became apparent that the area was overbuilt, vacancies were running very high, and taxes and operating costs were sharply rising. (R. 128-135, 157-167.)

Both the taxpayers and the FHA made careful financial analyses of the development before it was built. (R. 195-196, 211-213, 328.) These studies indicated that the development would be self-liquidating, *i.e.*, that the revenues would be sufficient to amortize the mortgage loans and pay interest thereon, and also provide a satisfactory return. The FHA estimated that the annual return after debt servicing would be about $78,000. The taxpayers counted on a return of at least $45,000. (R. 196, 212, 265, 328.) These computations were based on assumed vacancies of 7 percent for both apartments and garages. (R. 195, 211.) The taxpayers anticipated hardly any vacancies at all because of their success in other FHA projects and the tremendous demand for apartments. (R. 163,

164.) However, toward the end of May, 1950, the taxpayers concluded that the development was threatened with an annual deficit of about $20,000, instead of a profit of at least $45,000. They decided to sell their stock before the situation deteriorated further. (R. 128-129, 133-135, 146-147, 157-158, 161-162, 166-167.)

The projected deficit was based on five items: a rental loss of $16,000 because vacancies were 9 instead of 7 percent (R. 128, 135)[3]; an extra cost of $10,000 for removing garbage, a service formerly rendered by the city (R. 129, 132-133, 135, 239, 267; Appendix A, *infra*, p. 10a)[4]; an additional cost of $10,000 for redecorating apartments vacated by tenants in violation of three-year leases (R. 134, 162)[5]; a further cost of $31,000 for free utilities to tenants to meet the new competition of neighboring projects (R. 239, 268; Appendix A, *infra*, pp. 10a-11a)[6]; and an increase of $30,000 in real estate taxes. (R. 70, 72-74, 129-132, 158, 239.)[7]

---

[3] On an annual basis every 2 percentage points over the 7 percent projected by the FHA meant a loss of about $16,000 in rental income. (R. 128, 135.) The percentage reflects the ratio of the total vacancies to the total gross potential rents as stipulated by the parties. (R. 237.)

[4] The city discontinued the service in April, 1949. (R. 330.)

[5] The FHA had assumed that the apartments would be redecorated once every three years. (R. 57, 63, 134.) In the first five months of 1950 there were about 70 turnovers, requiring an outlay of $125 to $200 per apartment, or about $10,000 for redecorating. (R. 134.) As of May, 1950, the taxpayers expected this extra expense to continue. (R. 135.)

[6] This cost was estimated on the basis of projections made by Consolidated Edison Company. (R. 133-134.)

[7] The real estate taxes were increased beyond the FHA estimates by about $20,000 due to larger assessed values fixed in February, 1950; and by about $10,000 due to a record rise in tax rates predicted between March and May, 1950, and materializing in June, 1950. (R. 130-131, 238-239.)

In the latter part of May, 1960, the taxpayers were approached by brokers on behalf of two prospective purchasers. (R. 126-128, 167, 177, 242.) On June 6, 1960, the taxpayers entered into an agreement to sell their stock in Springfield and Hill. (R. 242.) The closing was scheduled for not later than September 30th. (R. 243-244.) At the insistence of the buyers' attorney, the agreement included a provision requiring the taxpayers to leave only small amounts of cash in the corporations. (R. 244.) On August 25, 1960, pursuant to this provision, Springfield and Hill distributed to the taxpayers all but nominal amounts of cash. (R. 46-47, 60-63, 119, 173-176, 245-246.)

The sale was not completed in September because one of the buyers refused to go through with the purchase. (R. 249.) Meanwhile the vacancies had steadily risen to 13 percent, representing an annual rental loss of $48,000 above vacancies as originally estimated. (R. 237.)[9] As a result, the taxpayers became more anxious to sell their stock. (R. 129.) After further delays by the buyers, the sale was finally consummated on November 13, 1960. (R. 249.)

Shortly before the sale in November the purchasers asked the taxpayers to make the necessary arrangements for providing the tenants with gas and electricity. (R. 133-134.) After the sale, Springfield and Hill provided utilities free to their tenants. (R. 250.) The two corporations continued to own the development. (R. 250.)

The taxpayers remained active in the operation of rental properties held as long-term investments. They continued to hold their stock in four other FHA proj-

[9] See note 3, *supra*.

ects. These four had been completed in [illegible], [illegible] and early [illegible]. (R. [illegible].)[9] In [illegible] the taxpayers, in their individual capacities, built a shopping center which they still owned at the time of trial in November [illegible]. (R. [illegible], [illegible].) In [illegible] they organized a corporation which built a large apartment house. The corporation still owned the building at the time of trial. (R. [illegible].) In [illegible] they remodeled apartments and built stores on property which they had held for about ten years. (R. [illegible], [illegible].)

Each taxpayer reported his gains attributable to the sale and distributions as long-term capital gains under sections 117(a) and 115(d) of the 1939 Code. (R. [illegible]-251; Appendix B, *infra*, pp. [illegible].)[10] The Commissioner determined that the gains were taxable as ordinary income on the ground that Springfield and Hill were collapsible corporations within section 117(m). The Tax Court sustained the Commissioner's determination. (R. [illegible].) Judge Kern dissented. He was the only judge who heard the testimony. (R. [illegible].) The Court of Appeals affirmed the decision of the Tax Court. (R. [illegible]-341.)

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[9] On November 28, 1949, the taxpayers sold their stock in a fifth project after holding it over four years. The sale was due to a very good offer. They had not been looking for a purchaser. As the Tax Court found, solely on the basis of Neidens' testimony, the sale was solicited by a broker on behalf of the buyer. (R. 49, 70, 104, 167.)

[10] Neither corporation had any accumulated earnings or profits at the time of the distributions, or any earnings or profits for its taxable year in which the distributions were made. (R. 209.)

REASONS FOR GRANTING THE WRIT

The gains realized on the sale and the distributions are taxable as long-term capital gains unless section 117(m) applies. Int. Rev. Code of 1939, §§ 115(d), 117(a). Section 117(m) was enacted in 1950,[11] and re-enacted as section 341 of the Internal Revenue Code of 1954. It provides that gain "from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation" is taxable as ordinary income. A collapsible corporation is defined as:

> "a corporation formed or availed of principally for the manufacture, construction, or production of property . . . with a view to—
>
> "(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and
>
> "(ii) the realization by such shareholders of gain attributable to such property."

I

The decision below is directly and admittedly in conflict with the decision of the Court of Appeals for the Fifth Circuit in *United States v. Ivey*, 294 F. 2d 799 (1961), *rehearing denied*, 62-1 U.S.T.C. ¶9477 (1962).

Section 117(m) is a penal provision. As its legislative history discloses, it is narrowly concerned with corporations used to construct or produce property in order to obtain a special tax benefit for stockholders through a quick distribution or sale of stock. That benefit consists of having the usual profit earned on the

[11] Revenue Act of 1950, § 212(a).

property taxed as a capital gain, where the same profit would be ordinary income if the corporation had realized it in the regular course of business or if the enterprise had been individually owned and operated. In short, section 117(m) was designed to prevent the conversion of what is normally ordinary income into a capital gain. A corporation is collapsible only if it was used for construction with a view to the realization of a capital gain, attributable to the constructed property, which would otherwise be realized as ordinary income. See H.R. Rep. No. 2319, 81st Cong., 2d Sess. 56-57, 97 (1950); Sen. Rep. No. 2375, 81st Cong., 2d Sess. 45, 89 (1950); Hearings before the Committee on Ways and Means on Revenue Revision of 1950, 81st Cong., 2d Sess. 5, 20, 70-71, 139-141 (1950).

In *United States* v. *Ivey*, *supra*, the taxpayer similarly owned stock in a corporation which built an apartment house. The Fifth Circuit held that section 117 (m) does not apply to the profit realized on the sale of such stock, where the profit would have been taxable as a capital gain if the stockholders had owned the property individually. The statute, the court held, "does not penalize the taxpayer by converting his capital gain into ordinary income." It does not apply to taxpayers "who would have been entitled to capital gains treatment without incorporating." 294 F. 2d at 802. The opinion concludes that the statute "should not be read as applicable to cases where the shareholder's gain would be taxable as a capital gain had he realized it directly rather than through the corporate vehicle." Any attempt to apply it in that situation would impose an "irrational hardship." *Id.* at 803-805. On petition for rehearing, the Fifth Circuit reaffirmed its conclusion, after fully reconsidering the

authorities and arguments submitted by the Government. 62-1 U.S.T.C. ¶ 9477 (1962).

Under the *Ivey* decision Springfield and Hill were not collapsible corporations because they were not used as a means of converting ordinary business income into capital gain. The development owned by the corporations was property used in a trade or business. It was not property held primarily for sale to customers in the regular course of business. If the corporations had directly sold the development, the profit would have been a capital gain. Int. Rev. Code of 1939, § 117(j), re-enacted as Int. Rev. Code of 1954, § 1231. Similarly, if the taxpayers had individually owned the development and then sold it, the profit would have also been a capital gain. The taxpayers did not hold rental property for sale to customers in the ordinary course of business. (R. 97-101, 186-187; pp. 2-3, *supra.*) The sale of the stock instead of the assets produced the same capital gain.[12] The attempted application of section 117(m) converts what would otherwise be capital gain into ordinary income.

The court below fully recognized that under the *Ivey* decision, the profits involved here are taxable as capital gains. It squarely disapproved the *Ivey* decision in the following language (Appendix A, *infra*, p. 15a):

> "The taxpayers' final argument[13] is that § 117 (m) should not apply if the constructed apartment buildings would have produced capital gain

[12] In this connection, the Tax Court specifically found, as the Commissioner stipulated, that the taxpayers' shares in Springfield and Hill were not property held primarily for sale to customers in the ordinary course of trade or business. (R. 250.)

[13] The court below refers to the taxpayers' reliance on the *Ivey* case as their "final argument." Appendix A, *infra*, p. 15a. Actually, it was the taxpayers' very first argument in their brief and oral presentation below.

on a sale by the taxpayers had no corporation been formed. We reject this argument which has, however, been recently accepted by the Fifth Circuit in *United States* v. *Ivey*, 294 F. 2d 799 (5th Cir. 1961) (2-1), rehearing denied with opinion, F. 2d (1962) (2-1).'"[14]

The express conflict between the Second and Fifth Circuits presents an important question of law which affects many taxpayers—especially those engaged in the construction of apartment houses, office buildings, and all other income-producing properties which qualify as capital assets. This question is a continuing problem under the 1954 Code as well as the 1939 Code. The *Ivey* case itself involved section 341 of the 1954 Code, which has replaced section 117(m) of the 1939 Code. The Senate Finance Committee has particularly indicated the need for an authoritative resolution of the problem. After carefully reviewing the problem, the Committee reported that the statute, as administered and applied, may have precisely the opposite effect from that intended. Instead of preventing the conversion of ordinary income into capital gain, it would convert capital gain into ordinary income. Sen. Rep. No. 1983, 85th Cong., 2d Sess. 31-32, 34 (1958). See also Statement of Chairman Mills of the Ways and Means Committee, 104 Cong. Rec. 17819 (1958).

II

The decision below presents another important issue for review which involves the basic reach and scope of section 117(m). That section does not apply unless the property was constructed "with a view to" the realization of a capital gain through a quick sale or distribu-

[14] Actually the Fifth Circuit's decision on the issue involved here was unanimous—not "2-1."

tion. "Congress is here indicating *a state of mind* which must attend and give significance to certain action." (Italics supplied.) *Jacobson* v. *Commissioner,* 281 F. 2d 703, 705 (3d Cir. 1960). The special liability imposed by the statute depends on the subjective purpose which prompted the construction of the property. The decision below drastically departs from the statute by arbitrarily applying objective tests of liability instead of the subjective standard fixed by Congress. Under these objective tests the taxpayer's actual purpose or state of mind becomes irrelevant.

In applying its objective tests, the Court of Appeals expressly recognized that the evidentiary facts are not in dispute. Appendix A, *infra,* p. 5a, n. 4. The salient evidentiary facts include the following:

(a) The taxpayers made no attempt to sell their stock in 1949—when their profit would have been clearly taxable as a capital gain.

(b) For months after the project was completed, the taxpayers refused to consider a sale in response to offers to buy.

(c) Throughout the 20 years of their joint enterprise, the taxpayers never sold any of their rental properties for a quick gain.

(d) The taxpayers decided to sell in May, 1950, only after the area was overbuilt, vacancies became and remained excessive,[15] taxes were sharply rising, additional expenses were incurred for garbage removal and redecoration, and revenues had to be reduced by furnishing free utilities to tenants.

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[15] The Court of Appeals conceded that the vacancies were excessive and the vacancy rate was high. Appendix A, *infra.* p. 11a.

(e) The taxpayers still held four other FHA projects built before Oakland Gardens, when they sold their stock in Springfield and Hill.

(f) Between the decision to sell in May, 1950, and the eventual sale in November, 1950, the rental loss, on an annual basis, rose from $16,000 to $48,000.

On these facts Judge Kern, the only judge who heard the examination and cross-examination of the witnesses, found for the taxpayers. He concluded that their decision to sell was attributable solely to circumstances which arose after construction. (R. 280-281.) As this Court has stated, "Findings as to the design, motive and intent with which men act depend peculiarly upon the credit given to witnesses by those who see and hear them." *United States* v. *Yellow Cab Company*, 338 U.S. 338, 341 (1949). See also *Universal Camera Corp.* v. *Labor Board*, 340 U.S. 474, 496 (1951).

If the subjective test of probing the taxpayers' mind is applied, the above undisputed facts simply cannot be ignored. Yet the court below gave no weight to them. Most of these significant undisputed facts are not even mentioned in the opinion. Instead the court arbitrarily resorts to objective tests which, in its view, compel a decision against the taxpayers, regardless of what they actually intended or contemplated.

(1) The court states that the taxpayers did not invest substantial amounts of capital in the project, that the corporations made interest-free loans to the taxpayers, and that the underlying land of the development was owned by the taxpayers' wives. Then it concludes:

> "These facts—nominal capitalization, interest-free loans, and ownership of the land by the tax-

payers' wives—while not necessarily inconsistent with Neisloss' testimony that the taxpayers intended to hold Springfield and Hill as long-term investments, lend little support to it." Appendix A, *infra*, p. 8a.

The objective nature of this test is evident from the court's own admission that the facts it selects are not inconsistent with the testimony. These facts, concededly, do not impeach Neisloss' veracity. But because they do not "support" his testimony, the court reasons that the testimony, however well corroborated, must be disregarded. In other words, the "objective facts" singled out by the court must be absent before it can be found that the taxpayer intended to hold property as a long-term investment.

It is, of course, true that the taxpayers did not select Springfield and Hill as the sole "long-term repositories of their wealth." Instead, they diversified their building investments, putting no more capital into any one project then the FHA deemed necessary, consistent with the FHA policy of expanding the construction of rental housing for veterans. The court's reasoning comes down to this: Since the taxpayers' testimony was not "supported" by the unbusinesslike policy of putting unnecessary capital into the project, their testimony may be disregarded. This is certainly an objective test. It has no relevance whatever to the taxpayers' actual subjective purpose or "view." Nor, even using the court's approach, has it any relevance to standard business judgment, which ordinarily regards diversification as a good long-term investment policy.

(2) The court does not dispute any of the items on the basis of which the taxpayers anticipated a deficit of

$20,000. But exercising its own business judgment, the court declares that the loss from vacancies and the cost of redecorating cannot be considered cumulatively with the conceded unexpected cost of free utilities. The court states:

> "Since Springfield's and Hill's failure to meet competition during these months (the first half of 1950) was probably a major cause of their high vacancy rate and since the taxpayers had decided to supply free utilities, the loss of revenues from excessive vacancies must be disregarded in predicting the projects' future net cash income. Similarly, once Springfield and Hill met competition the turnover of tenants would be reduced and the claimed redecorating costs *pro tanto* reduced. Thus the increased decorating costs and reduced rental income cannot be considered cumulatively with the cost of gas and electricity, but should be considered alternatively." Appendix A, *infra*, p. 11a.

Here the court has said that if the taxpayers had spent $31,000 annually for free utilities to tenants in order to meet competition, they would have eliminated undue vacancies in spite of the depressed character of the rental market. But this "business" judgment of the court can have no relevance in impeaching the business judgment of the more experienced taxpayers, who decided that the additional expense of $31,000 was a poor risk. In substituting its own judgment for that of the taxpayers, the court has plainly departed from the language and policy of section 117(m). That statute requires an evaluation of what was in the taxpayers' minds—not an evaluation of their business acumen.

The court's rigid rule of behavior is particularly arbitrary here. As of May, 1950, the corporations

would have had to spend $31,000 for utilities in an effort to restore $16,000 of income. Furthermore—and this the court below completely disregards—a substantial part of the rental loss was due to high vacancies in the garages. These vacancies were in no way related to the provision of free utilities. (R. 235-237.)[16] Finally, the court freely assumes that if utilities were supplied to tenants, competitors would become supine, excessive vacancies in apartments would automatically disappear, and redecorating costs would promptly decline. This is merely arbitrary conjecture in which the court has indulged on its own, without any evidence even as to the nature of the competing projects. An attempt to overcome business difficulties does not in the least mean that the effort will necessarily succeed.

(3) Apparently the court finally felt that its objective appraisal required more than its speculative presumption of what the taxpayers' view should have been. And so it bolstered its objective business judgment with still another such judgment. The court points out that each corporation showed a cash surplus for the period before and after May, 1950. "Taking the unexpected costs of utilities and garbage removal into account," the court states, "the project would still have been expected to produce an annual cash surplus." The court then concludes:

> "It is difficult to believe that this small decrease, which is all the taxpayers had cause to expect, would have caused experienced real estate operators like the three taxpayers to sell their stock

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[16] Garage vacancies average 57.8 percent a month in Springfield and 61.3 percent in Hill. (R. 236-237.) The FHA had estimated these vacancies at 7 percent. (R. 195, 211.)

unless they had a previous view to its sale. Were the courts to permit any minor adversity to serve as the pretext for a previously contemplated disposition, the collapsible corporation provision would indeed have a narrow scope. Thus, we must distinguish between those events which truly motivate a change in existing plans and those which merely operate as a trigger." Appendix A, *infra*, p. 12a.

Even if the court's analysis is assumed to be valid—and it is not[17]—the court has again applied an objective test in lieu of the subjective standard established by the statute. The court holds that even though the project was in serious financial straits, the sale could not have been a business decision in response to the admitted difficulties. Taxpayers are thus arbitrarily presumed to have built a project "with a view to" its sale if they eventually sell before the corporate surplus is exhausted. They cannot choose the alternative of selling out, as businessmen commonly do when faced with developing difficulties. In other words, the honesty of a businessman's decision is impeached by disagreeing with his judgment. But the one and only question under the statute is whether the taxpayers in

[17] The Court of Appeals' computations of cash surplus are grossly misleading, for it ignores the conceded increase in real estate taxes, which the taxpayers likewise had "cause to expect" together with the cost of furnishing free utilities. See Appendix C, *infra*, p. 26a. As Appendix C shows, the surplus of three of the four years would be converted into a deficit if only the increased real estate taxes were taken into account.

Furthermore, at several points the court seems to suggest that the taxpayers have attributed the sale to an actual cash deficit. The taxpayers' case is not that a deficit had already materialized, but that it was imminent as of May, 1950—and that their decision to sell was based on their business evaluation of the situation at that time.

May, 1950 genuinely feared the onset of a deficit—not whether their judgment or solution should have been different. Section 117(m) "does not require the taxpayer to be an incorrigible optimist." *Cf. United States* v. *White Dental Co.*, 274 U.S. 398, 403 (1927). Nor does it in any way impinge on his exercise of judgment and discretion amid the inevitable vicissitudes of private enterprise.

The objective tests applied by the court below conflict with the subjective standard applied by the Third Circuit in *Jacobson* v. *Commissioner, supra,* at 705. They raise an important question of statutory construction which radiates far beyond this case. In our economy a businessman has no choice but to operate on the basis of his own predictions in the light of shifting contingencies. In business, as elsewhere, there are no certainties. "Every year if not every day we have to wager our salvation upon some prophecy based upon imperfect knowledge." Holmes, J., in *Abrams* v. *United States*, 250 U.S. 616, 630 (1918). Section 117(m) is not a license which enables the Commissioner to second-guess the business decisions of taxpayers through the wisdom of hindsight. He has more than enough to do without engaging vicariously in real estate ventures or some other enterprise. The opinion below makes it impossible for taxpayers to conduct their affairs in normal fashion, and without fear of harsh consequences, retroactively imposed, because their judgment will be questioned. The court's decision is particularly harassing in view of Treasury assurances to Congress that the statute would not penalize the customary business decisions of taxpayers. See Hearings before the Committee on Ways and Means on Revenue Revision of 1950, 81st Cong., 2d Sess. 139-141 (1950).

CONCLUSION

For the foregoing reasons the petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 256-7-8—September Term, 1961

(Argued May 22, 1962 Decided July 6, 1962)

Docket Nos. 27146-7-8

BENJAMIN BRAUNSTEIN and DIANA BRAUNSTEIN; Estate of BENJAMIN NEISLOSS, Deceased, JULIA NEISLOSS and RUSSELL NEISLOSS, Executors and JULIA NEISLOSS; HARRY NEISLOSS and LILLIAN NEISLOSS, *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Before: LUMBARD, *Chief Judge,* SMITH and MARSHALL, *Circuit Judges.*

Petition to review a decision of the Tax Court of the United States, Turner, *Judge,* holding that two corporations were collapsible corporations under § 117(m) of the Internal Revenue Code of 1939 and thus their shareholders recognized ordinary income on the sale of the stock of the corporations and the receipt of distributions from the corporations. 36 T. C. 22 (1961).

Affirmed.

THURMAN ARNOLD and LOUIS EISENSTEIN, Washington, D. C. (Julius M. Greisman and Arnold, Fortas & Porter, Washington, D. C., on the brief), *for petitioners.*

DAVID O. WALTER, Department of Justice, Washington, D. C. (Louis F. Oberdorfer, Assistant Attorney General, Lee A. Jackson and Harry Baum, Department of Justice, on the brief), *for respondent.*

LUMBARD, *Chief Judge:*

The taxpayers,[1] who had previously been active in constructing homes and apartment buildings, formed two cor-

porations in 1948 for the purpose of building apartment houses in a development called Oakland Gardens in Bayside, Queens County, New York, to be financed under § 608 of the National Housing Act.[2] The Federal Housing Administration (FHA) guaranteed mortgage loans to the two corporations which then built the proposed projects. Each corporation had an excess of mortgage loan funds remaining after the costs of construction had been paid. In 1950, the year following completion of construction, the three taxpayers sold their stock in both corporations at a profit and, as part of the sale transaction, received distributions which included the excess mortgage funds from the two corporations. The taxpayers reported the excess of the amounts they received—both on the distributions from the corporations and on sale of their stock—over their bases in the stock and the expenses of sale as long-term capital gains of $313,854.17 each. The Commissioner asserted that the two corporations were collapsible corporations under § 117(m) of the Internal Revenue Code of 1939[3] so that the

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1 Diana Braunstein, Julia Neisloss, and Lillian Neisloss are included in this proceeding only because they filed joint returns with their husbands, Benjamin Braunstein, Benjamin Neisloss and Harry Neisloss, respectively. The three husbands will herein be referred to as the taxpayers. Benjamin Neisloss is now deceased, his estate having been substituted as a party herein.

2 The taxpayers formed two corporations rather than one because § 608(b)(3) of the National Housing Act, 12 U.S.C. § 1743(b)(3), prohibits loans beyond $5,000,000 to any one mortgagor.

3 § 117(m)—

"(1) Treatment of gain to shareholders.—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

"(2) Definitions.—

"(A) For the purpose of this subsection, the term, 'collapsible corporation' means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

gains from the distributions and from the sale of the stock were ordinary income. In a decision which was reviewed by the full court, the Tax Court upheld the Commissioner with one judge dissenting. 36 T. C. 22 (1961). The taxpayers appeal, and we affirm.

The Taxpayers Had the Requisite View During Construction

According to § 117(m)(1) of the 1939 Code, gain from the sale or exchange of stock of a "collapsible corporation," which gain, but for § 117(m), would be long-term capital gain, is ordinary income. According to § 117(m)(2)(A), a corporation is a "collapsible corporation" if it is formed or availed of principally for the construction of property "with a view to * * * the sale or exchange of stock by its shareholders * * * or a distribution to its shareholders,

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"(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

"(ii) the realization by such shareholders of gain attributable to such property.

* * * * *

"(3) Limitations on application of subsection.—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

"(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

"(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; and

"(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production. * * *"

[As added by § 212(a) of the Revenue Act of 1950, c. 994, 64 Stat. 906.]

prior to the realization by the corporation * * * constructing * * * the property of a substantial part of the net income to be derived from such property" and "with a view to * * * the realization by such shareholders of gain attributable to such property." This "view" is present "whether such action [sale or exchange of the stock or distribution to shareholders] was contemplated unconditionally, conditionally, or as a recognized possibility." Treas. Reg. 111, § 29.117-11(b) (1953). The "view" to such sale or distribution must exist at some time "during construction." Treas. Reg. 111, § 29.117-11(b) (1953). See *Jacobson* v. *Commissioner*, 281 F. 2d 703 (3 Cir. 1960). But see *Glickman* v. *Commissioner*, 256 F. 2d 108, 110-11 (2 Cir. 1958) (dictum). Thus, if "the sale, exchange, or distribution is attributable to circumstances present at the time of * * * construction * * * the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of." Treas. Reg. 111, § 29.117-11(b) (1953). The regulations state that when a corporation's construction of property is substantial in relation to its other activities and its shareholders sell their stock or receive a distribution, thus recognizing a gain before the corporation has realized a substantial part of the net income from the property, these facts will ordinarily be sufficient, in the absence of other facts, to establish that the corporation is collapsible. Treas. Reg. 111, § 29.117-11(d) (1953).

In an attempt to satisfy their burden of proof that they did not have the requisite view to sale or distribution during construction the taxpayers make two main arguments. They contend that they intended the two corporations to be repositories for the accumulation of substantial estates for their families, and thus meant the corporations to be long-term investments. They further contend that the distributions and sales were attributable to an unanticipated decline in the profitability of the two corporations—a decrease in rent income and an increase in expenses—which occurred

after construction was completed. The Tax Court found that although the taxpayers may have been attempting to make profits, the facts were inconsistent with the use of the two corporations as a repository for these profits. The Tax Court also found that the facts did not bear out the taxpayers' claims that there was an unexpected decline in profitability after the completion of construction. We conclude that the Tax Court was not wrong when it found that the taxpayers had the requisite "view" prior to the completion of the two projects.[4]

Although Benjamin Neisloss testified that the two corporations were intended as a long-term repository for the accumulation of a large estate, the Tax Court need not accept the unsupported testimony of an interested party. See, e.g., *Hartman* v. *Commissioner*, 296 F. 2d 726, 727-28 (2 Cir. 1961); *Payne* v. *Commissioner*, 268 F. 2d 617, 621 (5 Cir. 1959); *Cohen* v. *Commissioner*, 148 F. 2d 336 (2 Cir. 1945). Thus it is necessary for us to examine the facts to see if they lend support to the taxpayers' contention.

Benjamin and Harry Neisloss were brothers active in various real estate construction enterprises since 1919. Benjamin Braunstein is an architect who had been associated with the other two since about 1930. Beginning in 1943 the three taxpayers organized and were equal stockholders in seven corporations which constructed multiple dwelling garden-type apartments financed under § 608 of the National Housing Act. After the passage of between one and ten years from the completion of these projects, the taxpayers sold their stock in the seven corporations in 1949, 1950, and 1953. This case concerns the distribution of cash and the sale of the stock of two of these corporations.

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[4] Although Judge Kern, the only judge to hear the oral testimony, dissented, the weight of the Tax Court's findings is not lessened because, as Judge Kern recognized, few of "the evidentiary facts are themselves in dispute," 36 TC at 88.

On March 31, 1948 Springfield Development Company, Inc., and Hill Development Company, Inc., were incorporated. Each of the three taxpayers purchased ten shares of the common A stock of each corporation for $1 per share. The FHA purchased 100 shares of each corporation's preferred stock for $1 per share. Thus the two corporations' total paid-in capital was only $260. The taxpayers and their other corporations made loans to Springfield and Hill which were repaid out of the mortgage loan proceeds. Although such a nominal capitalization is not wholly inconsistent with the taxpayers' claims that they intended Springfield and Hill as a repository for the accumulation of their estates, it certainly does not lend weight to their contentions.

Previously the taxpayers had obtained a commitment from the FHA for mortgage loan insurance for the two projects, which were in fact parts of a single overall development. The FHA's total estimated cost of the projects was $6,845,804 and the total mortgage insurance commitments were $6,101,600. Both corporations entered into loan agreements with the Bank of Manhattan Company to advance the amount of the FHA mortgage insurance commitment with 4% interest.

Springfield and Hill entered into contracts with the N. B. Construction Company, Inc., of which the three taxpayers were equal shareholders, for the construction of the projects.[5] Although these contracts specified a lump sum consideration, in practice Springfield and Hill merely reimbursed N. B. Construction for its costs.

Construction was begun in April 1948 and the various buildings were completed between September 1948 and June 1949. The costs of construction were less than had been estimated. Instead of contracting out the carpentry

[5] This corporation was later succeeded by N. B. Construction Company, a partnership consisting of the three taxpayers, which completed the work. The corporation and partnership are regarded as interchangeable for purposes of this opinion.

and plumbing work, the taxpayers had their own men do the work, saving $80,000 on carpentry and $85,000 on plumbing and heating. A decline in the cost of lumber resulted in a saving of $50,000. There were other savings amounting to nearly $90,000 in title and recording expenses and legal and organizational expenses. Furthermore, the FHA cost estimates had included $599,741 as the total builder's and architect's fees to be incurred by Springfield and Hill. N. B. Construction acted as builder (in addition to doing the construction work) and Benjamin Braunstein acted as achitect for the two corporations without pay,[6] thus saving nearly $600,000 more.

Thus the mortgage loan proceeds exceeded the cash expenditures in constructing the two projects by more than $150,000. These excess funds were not used to prepay a part of the corporations' large mortgage indebtedness which was costing them 4% interest. Rather, these funds were loaned interest free to the taxpayers' other construction projects. Therefore, Springfield and Hill, far from accumulating the taxpayers' estate, were incurring uncompensated interest expenses while taxpayers' other corporations used the money to make a profit.

The land on which these projects were built was not owned by Springfield and Hill. In April and May 1947 Benjamin Neisloss entered into contracts to purchase the land for $120,000. On December 15, 1947, this land was conveyed to the wives of the three taxpayers who leased it to Springfield and Hill for 99 years at a total annual rental of $23,824, a rate which would repay the original cost in five years. In the FHA project analysis it was estimated that this land would be worth $595,600, five times its purchase price, after the projects were built. Although the legality or the propriety of this transaction is not questioned, it is

[6] Both of their contracts called for payment of fees in Common B stock. But shortly after entering these contracts both N. B. Construction and Braunstein released Springfield and Hill from their obligations to transfer the Common B stock.

evident that burdening the corporations with a substantial long-term rent obligation and shifting the benefit of the increase in value of the land due to the construction thereon from the corporations to the taxpayers' wives are not consistent with the taxpayers' claimed purpose to make Springfield and Hill long-term repositories of their increased estates.

These facts—nominal capitalization, interest free loans, and ownership of the land by the taxpayers' wives—while not necessarily inconsistent with Neisloss' testimony that the taxpayers intended to hold Springfield and Hill as long-term investments, lend little support to it. We turn now to the taxpayers' other contention, that the decision to sell was due solely to circumstances arising after construction which could not reasonably have been anticipated at the time of construction.

In making application for mortgage loan insurance the taxpayers submitted estimate of Springfield's and Hill's annual income and expenses. The FHA in making a project analysis made their own estimates. Rather than computing projected net income, the taxpayers and the FHA estimated net cash inflow, i.e., they started with estimated rent income and then deducted estimated cash expenses, estimated payments to the reserve for replacement of refrigerators, stoves, and equipment to be held by the mortgagee, and the amount of annual debt service (interest and principal payments and the cost of mortgage insurance), thus arriving at "Cash available for income taxes, corporate taxes, dividends and surplus." The estimates were as follows:

	FHA Estimate	Taxpayers' Estimate
Springfield	$53,925	$28,361
Hill	24,916	16,631
Total	$78,841	$44,992

The Tax Court found that in entering into the project the taxpayers were relying upon their own estimates and not on the FHA's higher predictions.

The taxpayers claim that decreases in rental income which were not expected when construction was completed and increases in operating expenses which were also unanticipated reduced the cash available for taxes, dividends and surplus to a deficit of $20,000 per year, and that the projects, far from being self-liquidating, would then have required the taxpayers to make annual contributions to the corporations' capital. This unexpected turn of events, rather than a previously held view to sale, the taxpayers argue, prompted them to decide to sell in late May 1950. The taxpayers compute the $20,000 annual deficit as follows:

FHA's estimated annual cash surplus		$78,841
Less:	Increased real estate taxes	$30,000
	Cost of garbage and rubbish removal	10,000
	Cost of furnishing free gas and electricity to tenants	31,000
	Decline in rental income	16,000
	Increased costs of redecorating	10,000
		$97,000
Cash deficit		$18,159

After examining all these factors which the taxpayers allege contributed to the purported cash deficit of nearly $20,000, we find that there was in fact no cash deficit and that the project, although not doing quite as well as the taxpayers had predicted, was earning a cash surplus. It is necessary to examine each of the factors which purportedly contributed to this nearly $20,000 annual cash deficit.

During early 1950 the New York newspapers predicted a large real estate tax increase. When the rate on Springfield's and Hill's property was fixed in June 1950 these predictions proved true. The FHA's and the taxpayers' estimates of real estate taxes and the actual 1950-51 tax in total for Springfield and Hill are as follows:

FHA's Estimates	$133,668
Taxpayers' Estimate	168,617
Actual 1950-51 real estate tax	163,663

The taxpayers, in calculating their $20,000 annual cash deficit, rely upon the fact that actual real estate taxes exceeded the FHA's estimate by $30,000. However, since the actual tax fell $5,000 short of the taxpayers' own estimate, they cannot claim that the amount of the real estate taxes was an unexpected factor.

In April 1949 the City of New York discontinued its service of garbage and rubbish removal. Thus the projects were forced to procure this service from a private contractor at a cost of approximately $8,500 a year which had not been anticipated at the time the estimates were made. The government argues that since the taxpayers were aware of this expense just before construction was completed in June 1949, to the extent that it produced a view to sell, this view was held "during construction." See *Glickman* v. *Commissioner*, 256 F. 2d 108, 111 (2 Cir. 1958). However, it has been argued that if a view to sell first arose after all the decisions affecting construction had been made and construction was largely completed, the view did not arise early enough to make the corporation collapsible. McLean, Collapsible Corporations—The Statute and Regulations, 67 Harv. L. Rev. 55, 61-62 (1953). Even accepting *arguendo* the latter position, we think that the Tax Court was correct. Thus we assume that this expense of $8,500 per year arose after construction was sufficiently near completion.

Springfield and Hill had not intended to provide free gas and electricity to their tenants. However, since various

competing projects did provide free utilities, Springfield and Hill had difficulty attracting and retaining tenants. Thus, by May 1950 the taxpayers decided that Springfield and Hill would have to meet competition and furnish free utilities. The cost of such a step was estimated at $31,000 per year. It appears that this expense was unexpected and might have reduced the projects' profitability unless the rents were increased slightly. Although the Federal Housing Regulations did not permit the taxpayers to increase rents without the district director's approval, Neisloss testified that the FHA entertained applications for increases if actual operating costs exceed the estimates. Of course, the competitive situation might have prevented an increase in rents and to that extent the cost of utilities would have reduced the net cash income.

The taxpayers also claim that the vacancy rates exceeded the 7% vacancies used by the FHA and the taxpayers in making their estimates. However, during the period in question, the first half of 1950, the taxpayers had not yet begun to supply free utilities. Since Springfield's and Hill's failure to meet competition during these months was probably a major cause of their high vacancy rate and since the taxpayers had decided to supply free utilities, the loss of revenues from excessive vacancies must be disregarded in predicting the projects' future net cash income. Similarly, once Springfield and Hill met competition the turnover of tenants would be reduced and the claimed redecorating costs *pro tanto* reduced. Thus the increased decorating costs and reduced rental income cannot be considered cumulatively with the cost of gas and electricity, but should be considered alternatively.

Taking the unexpected cost of utilities and garbage removal into account, the project would still have been expected to produce an annual cash surplus. The two corporations' actual results for the period before and after May 1950 bear out this conclusion. Before construction had begun the taxpayers estimated that Springfield's an-

nual cash surplus would be $28,361 and Hill's $16,631. The projects' actual cash surplus was as follows:[7]

	1950	1951
Springfield (Year ended Aug. 31)	$85,133	$27,351
Hill (Year ended Jan. 1)	8,978	11,596

It is difficult to believe that this small decrease, which is all the taxpayers had cause to expect, would have caused experienced real estate operators like the three taxpayers to sell their stock unless they had a previous view to its sale. Were the courts to permit any minor adversity to serve as the pretext for a previously contemplated disposition, the collapsible corporation provision would indeed have a narrow scope. Thus, we must distinguish between those events which truly motivate a change in existing plans and those which merely operate as a trigger.

The taxpayers argue that this analysis is altogether too objective since the question in issue is whether the taxpayers subjectively had a view to sell during construction. However, only by determining the objective facts and attempting to ascertain their effect on the taxpayers' minds can the court assess Benjamin Neisloss' self-serving testimony that the taxpayers had no view to sell until after construction had been completed.[8]

In late May 1950 the taxpayers were approached by brokers on behalf of prospective purchasers, and in early

[7] These figures were obtained by taking each corporation's net loss as reported on its federal income tax return, adding back non-cash depreciation expense and interest and insurance on the mortgage, and then subtracting the FHA's estimated annual payments for debt service (including interest and principal and mortgage insurance) and the annual payments to the reserve for replacement of equipment.

[8] McLean, Collapsible Corporations—The Statute and Regulations, 67 Harv. L. Rev. 55, 65-66 (1953); DeWind & Anthoine, Collapsible Corporations, 56 Colum. L. Rev. 475, 483 (1956).

June a contract was signed setting the price for all of Springfield's and Hill's stock at $400,000 subject to various plus and minus adjustments. Since the purchasers did not want to pay for a large amount of cash held by the corporations, Springfield and Hill increased the book value of its assets and declared dividends to the taxpayers totalling $555,000.[9] Since neither Springfield nor Hill had any accumulated earnings and profits at the time of the distribution or any earnings and profits for its taxable year in which the distributions were made, the distributions were not dividends for income tax purposes. Internal Revenue Code of 1939, § 115(a).[10] The final sale price of all the stock was $399,702. Taxpayers reported a total long-term capital gain on their 1950 income tax returns as follows:

Distributions from Springfield and Hill	$555,000
Selling price of Springfield and Hill stock	399,702
	$954,702
Less	
Cost of stock	$ 60
Expenses of sale	13,079
	$ 13,139
Gain	$941,563

[9] Since Springfield and Hill had loaned most of their excess cash to taxpayers' other enterprises, part of the $555,000 distribution was made by a set of bookkkeeping entries rather than through an actual cash distribution.

[10] Section 312(j) of the 1954 Code, applicable to distributions made after June 22, 1954, would have caused these distributions to be treated as dividends by increasing the corporations' earnings and profits by the amount of the excess of the FHA guaranteed loans over the adjusted basis of the buildings. However, under the 1939 Code, unless the collapsible corporation provision applies, the distributions would be treated as capital gains to the extent that they exceed the shareholder's basis. 1939 Code, § 115(d); *Commissioner v. Gross*, 236 F. 2d 612 (2 Cir. 1956), aff'g 23 TC 756 (1955).

Since we do not think that the Tax Court was wrong in concluding that the taxpayers had the requisite view to sale during construction, this gain is ordinary income unless for some other reason the collapsible corporation provision does not apply.

More than 70% of the Gain Was Attributable to the Constructed Property

Section 117(m) does not apply to this gain "unless more than 70 per centum of such gain is attributable to the property so * * * constructed." 1939 Code § 117(m)(3)(B). The taxpayers claim that more than 30% of the gain is due to retained rental income and that such gain is not "attributable to the property so * * * constructed." Since we find that less than 30% of the gain was due to retained income, we need not decide whether the regulations which broadly interpret "gain attributable to the property," apparently to include gain attributable to retained rental income, Treas. Reg. 111, § 29.117-11(c)(3), are valid. Compare *Spangler* v. *Commissioner*, 278 F. 2d 665, 670-71 (4 Cir. 1960), cert. denied, 364 U. S. 825 (1960); *Bryan* v. *Commissioner*, 281 F. 2d 238, 241 (4 Cir. 1960), cert. denied, 364 U. S. 931 (1961) (upholding the regulation), with McLean, *supra* note 8, at 79-80; DeWind & Anthoine, *supra* note 8, at 516; Anthoine, Recent Developments in Collapsible Corporations, New York University 14th Annual Institute on Federal Taxation 761, 782 (1956) (rejecting the regulation).

Springfield and Hill reported net losses on their income tax returns for the period that the taxpayers held their stock. However, in computing the amount of rental income that the two corporations accumulated, the taxpayers ask us to exclude two classes of deductions taken by the corporations on their income tax returns. But even if we agree with them as to the first, depreciation, which is a non-cash expense, the taxpayers' argument falls short. The monthly payments to the mortgagee for replacement of equipment

should then be regarded as coming out of operating revenues. The replacement of existing equipment is a prerequisite to continued operations. Therefore, we reject the taxpayers' claim that payments to the reserve for replacement should be treated as coming pro rata from the excess mortgage proceeds and the accumulated rental income. And we disagree with the taxpayers as to the second, interest and real estate taxes incurred during construction. Since the corporations chose to deduct these expenses on their income tax returns, we regard them as having been made out of operating income rather than out of the excess mortgage proceeds as the taxpayers argue. Consequently, less than 30% of the gain was due to accumulated operating income.

Section 117(m) Applies Even if Sale of the Corporate Assets Would Have Produced Capital Gain Had No Corporation Existed

The taxpayers' final argument is that § 117(m) should not apply if the constructed apartment buildings would have produced capital gain on a sale by the taxpayers had no corporation been formed. We reject this argument which has, however, been recently accepted by the Fifth Circuit in *United States* v. *Ivey*, 294 F. 2d 799 (5 Cir. 1961) (2-1), rehearing denied with opinion, —— F. 2d —— (1962) (2-1).[11] The argument goes as follows:

If a taxpayer who is engaged in a trade or business constructs an asset which he holds primarily for sale in the ordinary course of his trade or business, any gain from the sale of the asset is ordinary income. 1939 Code § 117 (a)(1)(A), (j)(1). Before the collapsible corporation provision was passed, a taxpayer could have formed a corporation to construct the asset and upon sale of the corpora-

[11] See also *Honaker Drilling, Inc.* v. *Koehler*, 190 F. Supp. 287 (D. Kan. 1960), where the district court utilized this argument to find that the corporation was not availed of with the requisite view.

tion's stock recognized capital gain instead of the ordinary income he would have received had no corporation been used. Therefore, the taxpayer argues, the collapsible corporation provision was enacted to give the taxpayer ordinary income on the sale of the stock just as he would have had ordinary income on the sale of the asset, and if the taxpayer, had he constructed and sold the asset himself, would not have had ordinary income on its sale, the collapsible corporation provision should not apply.

The collapsible corporation provision as literally written applies regardless of whether the assets constructed by the corporation would have produced capital gain or ordinary income if constructed and sold by the shareholder. Although this occasionally produces unwarranted taxation of capital gains as ordinary income, for the courts to rewrite the very complex legislation embodied in § 117(m) of the 1939 Code and its successor, § 341 of the 1954 Code, would produce even more confusion.[12]

The taxpayers in this case and the Fifth Circuit in *Ivey* assume that the sole purpose of the collapsible corporation provision was to deal with those cases where the shareholder would have had ordinary income if he had sold the assets himself. However, the legislative history discloses that § 117(m) has another major purpose. H. R. Rep. No. 2319, 81st Cong., 2d Sess. 56-57, 97 (1950); Sen. Rep. No. 2375, 81st Cong., 2d Sess. 45, 89 (1950); H. R. Rep. No. 586, 82nd Cong., 1st Sess. 25 (1951); Sen. Rep. No. 781, 82nd Cong., 1st Sess. 33 (1951). See also DeWind & Anthoine, *supra* note 8, at 475-77 (1956); Note, Legislative Response

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12 The commentators have generally assumed that the collapsible corporation section would be literally interpreted by the courts. See, e.g., DeWind & Anthoine, *supra* note 8, at 487, 508-09, 533; Anthoine, Collapsible Corporations; 1957 Developments, New York Univ. 16th Annual Institute on Federal Taxation 659, 661 (1958); 3B Mertens, Federal Income Taxation § 22.64, p. 271; Mertens, Federal Income Taxation, Code Commentary, § 341(b)(3): 1; Bittker, Federal Income Taxation of Corporations and Shareholders 309-10 (1959).

to the Collapsible Corporation, 51 Colum. L. Rev. 361-62 (1951); Bittker, *supra* note 12, at 299-300. If an individual made a movie or constructed an apartment building, income received from the rental of the movie or building would be ordinary income. Thus some taxpayers formed a corporation to make the movie or construct the apartment building and then liquidated the corporation after the movie or the building was finished. On liquidation the shareholders were taxed at capital gain rates on the difference between their basis in the stock and the fair market value of the movie or apartment building, but the shareholders' basis in the movie or apartment building was stepped-up to fair market value. The shareholders could then rent out the movie or apartment building and amortize or depreciate their stepped-up basis against rental income. Congress enacted § 117(m) to make the shareholders' gain on liquidation ordinary income rather than capital gain. If an individual had made a movie with the intention of renting it, he would have capital gain on a subsequent sale since it would not have been held primarily for sale to customers in the ordinary course of his trade or business. Therefore, the collapsible corporation provision was intended to apply to some cases when the asset if sold by the taxpayer would have produced capital gain. However, if the *Ivey* decision is applied where a movie is made by a corporation which is then dissolved, the collapsible corporation provision will have no application to the basic fact situation which prompted its enactment.

Of course, this difficulty could be remedied by interpreting the *Ivey* decision as applicable only to sales of stock and not to liquidations. Thus, when the stock of a corporation is sold, it would not be collapsible if the underlying assets would have produced capital gain had no corporation been used, but when a corporation is liquidated, it would be collapsible regardless of whether the underlying assets would have produced capital gain had no corporation been

formed. However, since Congress chose to use a single statute to deal with both types of cases, it seems unwise for the courts to create the additional complexities inherent in such a two-fold interpretation. In 1958 Congress, in fact, adopted slightly different tests for collapsibility on liquidation and on sale of stock. Compare 1954 Code § 341 (e)(1), with 1954 Code § 341(e)(2), (4). See Sen. Rep. No. 1983, 85th Cong., 2d Sess. 33-34 (1958). The multiplicity of detailed rules which this dual statutory test necessitated make it manifest that such an approach should not be effected by judicial decision.

Moreover, even as applied to the sale of stock situation, the *Ivey* decision departs from the Code's consistent framework for taxing collapsible corporations. According to the opinion denying a rehearing in *Ivey*, —— F. 2d —— (1962), if all the literal requirements of § 117(m) of the 1939 Code or its successor, § 341 of the 1954 Code, are satisfied, the court should disregard the shareholders' holding period for their stock and treat the shareholders as if they had owned the corporation's assets directly. Thus, any assets which the corporation has acquired within six months and which would be capital assets in the shareholders' hands will produce short-term capital gain while those held longer than six months will produce long-term capital gain. Regardless of the theoretical wisdom of this approach, it has no basis in the collapsible corporation provision which Congress has enacted. One of the clear policy decisions embodied in § 117(m) and its successor is the treatment of all or none of the gain as long-term capital gain, i.e., the refusal to split the gain between long-term capital gain and ordinary income. See Cohen, Tarleau, Surrey & Warren, A Proposed Revision of the Federal Income Tax Treatment of the Sale of a Business Enterprise—American Law Institute Draft, 54 Colum. L. Rev. 157, 173-74, 177 (1954); *Commissioner* v. *Kelley*, 293 F. 2d 904, 912-13 (5 Cir. 1961).

Furthermore, regardless of how compatible with the statute the *Ivey* interpretation may have been previous to 1958, the addition of § 341(e) in that year makes *Ivey's* interpretation of the collapsible corporation provision anomalous. Although § 341(e) did not completely eliminate the conversion of capital gain into ordinary income by the collapsible corporation provision, it was designed to narrow the imposition of ordinary income treatment in an *Ivey* type of case where the shareholder would have recognized capital gain had he constructed and sold the asset without the use of a corporation. Sen. Rep. No. 1983, 85th Cong., 2d Sess. 31-32 (1958); Bittker, *supra* note 12, at 310-313-14. However, *Ivey* went further than § 341(e) in narrowing the scope of the collapsible corporation provision.[13] Therefore, if *Ivey* is correct, either § 341(e) is unnecessary or, if it is regarded as overruling *Ivey*, it expands rather than contracts the application of the collapsible corporation provision, clearly the contrary of what Congress intended. See Sen. Rep. No. 1983, 85th Cong., 2d Sess. 31-32 (1958).

Although the courts must often interpret sections of the Internal Revenue Code in light of their purposes in order to carry out Congressional intent, see, e.g., *Corn Products Refining Co. v. Commissioner*, 350 U. S. 46, 52, 53-54 (1955); *Gregory v. Commissioner*, 293 U. S. 465 (1935), when this would require the courts to extensively rewrite clear statutory language, the task of revision should be left to Congress, see, e.g., *Hanover Bank v. Commissioner*, —— U. S. —— (1962).

Affirmed.

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[13] Section 341(e) was not applicable in *Ivey* since the operative facts had taken place before its enactment. Although § 341(e) had been enacted before the Fifth Circuit decided *Ivey*, the court did not discuss the statutory amendment.

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the sixth day of July one thousand nine hundred and sixty-two.

Present:

Hon. J. Edward Lumbard,
Chief Judge,
Hon. J. Joseph Smith,
Hon. Thurgood Marshall,
Circuit Judges

BENJAMIN BRAUNSTEIN AND DIANA BRAUNSTEIN, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Appeals from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States
, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. DANIEL FUSARO
Clerk

By

VINCENT A. CARLIN
Chief Deputy Clerk

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the sixth day of July one thousand nine hundred and sixty-two.

Present:

Hon. J. Edward Lumbard,
Chief Judge,
Hon. J. Joseph Smith,
Hon. Thurgood Marshall,
Circuit Judges

Estate of BENJAMIN NEISLOSS, Deceased,
JULIA H. NEISLOSS and RUSSEL NEISLOSS, Executors,
and JULIA NEISLOSS, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

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HARRY NEISLOSS and LILLIAN NEISLOSS, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

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Clerk
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Chief Deputy Clerk

APPENDIX B

Internal Revenue Code of 1939:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * *

(d) OTHER DISTRIBUTIONS FROM CAPITAL. If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.

* * * *

(26 U.S.C. 1952 ed., Sec. 115.)

SEC. 117. CAPITAL GAINS AND LOSSES.—(a) DEFINITIONS.—As used in this chapter—

(1) CAPITAL ASSETS. The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

* * * *

(4) LONG-TERM CAPITAL GAIN.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than six months, if and to the extent such gain is taken into account in computing net income;

* * * *

(j) GAINS AND LOSSES FROM INVOLUNTARY CONVERSION AND FROM THE SALE OR EXCHANGE OF CERTAIN PROPERTY USED IN THE TRADE OR BUSINESS.—

(1) Definition of Property Used in the Trade or Business.—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . . .

(2) General Rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, . . . exceed the recognized losses from such sales, exchanges, . . . such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than six months. . . .

(m) [As added by Sec. 212(a) of the Revenue Act of 1950, c. 994, 64 Stat. 906] *Collapsible Corporations*—

(1) Treatment of Gain to Shareholders.—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) Definitions.—

(A) For the purposes of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

(ii) the realization by such shareholders of gain attributable to such property.

* * * *

(3) Limitations on Application of Subsection.—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

* * * *

(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; and

(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production.

* * * *

(26 U.S.C. 1952 ed., Sec. 117.)

APPENDIX C

The Court of Appeals sets forth the following cash surplus (Appendix A, *supra*, p. 12a):

	1950	1951
Springfield (year ended August 31)	$85,133	$27,351
Hill (year ended January 31)	8,978	11,596

These figures are quite misleading because they completely disregard impending real estate taxes.

In the case of Springfield the surplus for fiscal 1950 did not yet reflect the full impact of those taxes. The taxes for that year were only $22,724.76, as compared with the imminent burden of $112,324.50 for fiscal 1951. (R. 240.) The difference then, was $89,599.74. In short, even apart from the cost of free utilities, Springfield as of 1950 faced a deficit of about $5,000 due to additional taxes.

In the case of Hill the court also ignores impending real estate taxes. The taxes for fiscal 1950 were only $2,645.53 (R. 241), as compared with $51,339, the amount fixed by the city in June, 1950—five months after the end of that fiscal year. (R. 263.) As applied to fiscal 1950, the difference of $48,693.47 would have converted the surplus of $8,978 into a cash deficit of $39,715.47. Similarly, in fiscal 1951 the new taxes on Hill were not yet fully effective for the entire year. They were only $31,100.63 (R. 241) instead of $51,339. As applied to fiscal 1951, the difference of $20,228.37 would have converted the cash surplus of $11,596 into a cash deficit of $8,632.37.

In the Supreme Court of the United States

October Term, 1962

No. 476

Benjamin Braunstein, et al., petitioners

v.

Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 184–281) are reported at 36 T.C. 22. The opinion of the court of appeals (Pet. 1a–19a) is reported at 305 F. 2d 949.

JURISDICTION

The judgments of the court of appeals were entered on July 6, 1962. (Pet. 20a–22a.) The petition for a writ of certiorari was filed on October 1, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether Section 117(m) of the Internal Revenue Code of 1939, which provides that gain "from the

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sale or exchange * * * of stock of a collapsible corporation" is taxable as ordinary income rather than capital gain, is inapplicable in circumstances where the stockholders would have been entitled to capital-gains treatment had they conducted the enterprise in their individual capacities without utilizing a corporation.

2. Whether, during the course of a corporation's construction of a building, the stockholders contemplated (had "a view to") their later sale of the stock shortly after construction was completed, thus making the corporation a "collapsible" one as defined in Section 117(m).

STATUTE INVOLVED

Section 117(m) of the Internal Revenue Code of 1939 is printed in the Appendix, *infra*, pp. 7-9.

STATEMENT

The essential facts are summarized in the opinion of the court of appeals (Pet. 1a-3a) as follows:

The taxpayers, Benjamin Braunstein, Benjamin Neisloss, and Harry Neisloss, who had previously been active in constructing homes and apartment buildings, formed two corporations in 1948 for the purpose of building apartment houses in a development called Oakland Gardens in Bayside, New York, to be financed under Section 608 of the National Housing Act. Each of the taxpayers invested a total of $10 in each of the two corporations (R. 199-200, 215). The Federal Housing Administration guaranteed mortgage loans to the two corporations, which then built the proposed projects. Each corporation

had an excess of mortgage loan funds remaining after the costs of construction had been paid. In 1950, the year following completion of construction, the three taxpayers sold their stock in both corporations at a profit, and as part of the sale received distributions which included the excess mortgage funds from the two corporations. Each taxpayer had a gain of $313,854.17 on the distribution and the sale of his stock (R. 251). They claimed that their gains were taxable as long-term capital gains. The Tax Court, with one dissent, and the court of appeals held the gains taxable as ordinary income pursuant to Section 117(m) of the Internal Revenue Code of 1939 as gains realized from distributions from and the sale of stock in collapsible corporations.

ARGUMENT

Section 117(m) of the 1939 Code provides that gain from the sale of stock of a "collapsible corporation" is to be taxed as ordinary income rather than capital gain. A "collapsible corporation" is defined as one "formed or availed of principally for the manufacture, construction, or production of property * * * with a view to—(i) the sale or exchange of stock by its shareholders * * * prior to the realization by the corporation * * * of a substantial part of the net income to be derived from such property, and (ii) the realization by such shareholders of gain attributable to such property." Petitioners argue (1) that Section 117(m)'s prescription of ordinary-income treatment is inapplicable here even if the corporation was, as the courts below found, "collapsible"; and (2)

that the finding below that the stockholders had the requisite "view" to make the corporation "collapsible" was based on an erroneous standard. We acquiesce in the granting of certiorari on the first issue but oppose its grant on the second.

1. The court below rejected petitioners' argument that a transaction falling within the express terms of the "collapsible corporation" provision should nevertheless be exempted from that provision if the taxpayer could have obtained capital gains treatment for the transaction by carrying it out without the use of a corporation (Pet. 15a–19a). This decision is in conflict with that of the Court of Appeals for the Fifth Circuit in *United States* v. *Ivey,* 294 F. 2d 799, rehearing denied with opinion, 303 F. 2d 109.[1] We believe the court below was clearly correct and the Fifth Circuit in the *Ivey* case clearly wrong. However, in view of the direct conflict between the two decisions and of the continuing importance of the question in the administration of the revenue laws, we do not oppose the granting of the petition on this issue.

2. The second question is solely one of fact—namely, what was the state of mind of the stockholders during the construction of the buildings. If they then contemplated "selling out" shortly after construction was

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[1] The court below relied in part upon Section 341(e) of the Code, enacted in 1958 (Pet. 19a), and noted that the Fifth Circuit in the *Ivey* case "did not discuss" this provision (Pet. 19a, n. 13). This circumstance does not suggest a lack of conflict, however, for the 1958 amendment was argued to the Fifth Circuit, and that court gave evidence of having considered the amendment by referring to its legislative history (294 F. 2d at 802).

completed, the corporation was a "collapsible" one as defined in Section 117(m). If at that time they did not contemplate an early sale, determining upon that course only after construction had been completed, the corporation may not have been collapsible. The Tax Court, affirmed by the court of appeals, found that the requisite "view" existed during the construction period. Whether that was a proper inference from the evidence is obviously not a question warranting review by this Court.

To avoid the impact of the clearly-erroneous rule, petitioners contend that the court below applied the wrong standards, substituting an "objective test" for the statute's subjective state-of-mind test (Pet. 11-18). The fact, however, is that, while the courts below examined the "objective" facts surrounding the transactions, they treated them not as ultimate facts but only as evidence from which to draw inferences about the stockholders' state of mind and the reasons for their actions. The court of appeals explained the relevance of its consideration of the surrounding facts by noting at the outset that the Tax Court was not bound to accept the unsupported testimony of the testifying stockholder, an interested party, about his state of mind (Pet. 5a), so that it was necessary to examine the other facts to see if the corroboration was so strong as to make the Tax Court's rejection of the testimony clearly erroneous. And having considered the "objective" facts and their implications in explaining the stockholders' actions, the court expressly reaffirmed the "subjective" nature of the

ultimate fact in issue and once again explained the limited relevance of the "objective" facts (Pet. 12a):

> * * * the question in issue is whether the taxpayers subjectively had a view to sell during construction. However, only by determining the objective facts and attempting to ascertain their effect on the taxpayers' minds can the court assess Benjamin Neisloss' self-serving testimony that the taxpayers had no view to sell until after construction had been completed.

The relevance of the objective facts so used cannot be doubted, and petitioners' ultimate complaint is simply over the validity of the inferences drawn—or refused to be drawn—from those facts, a question not meriting review here.

CONCLUSION

For the reasons stated, the petition for certiorari should be granted limited to Question 1 as stated in this brief (p. 2, *supra*).[2]

Respectfully submitted.

ARCHIBALD COX,
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JOHN B. JONES, JR.
Acting Assistant Attorney General.
HARRY BAUM,
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Attorneys.

NOVEMBER 1962.

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[2] The Question Presented in the petition did not separate the two distinct issues (Pet. 2).

APPENDIX

Section 117(m) of the Internal Revenue Code of 1939, as amended by Section 212(a) of the Revenue Act of 1950, 64 Stat. 906, 26 U.S.C. (1952 ed.) 117, provides:

* * * * * *

(m) *Collapsible Corporations.*—

(1) *Treatment of gain to shareholders.*—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) *Definitions.*—

(A) For the purposes of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

(ii) the realization by such shareholders of gain attributable to such property.

(B) For the purposes of subparagraph (A), a corporation shall be deemed to have manufactured, constructed, or produced the property, if—

(i) it engaged in the manufacture, construction, or production of such property to any extent,

(ii) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, or produced the property, or

(iii) it holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, or produced by the corporation.

(3) *Limitations on application of subsection.*—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

(B) this subsection shall not apply to the gain recognized during a taxable

year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; and

(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production.

For purposes of subparagraph (A), the ownership of stock shall be determined in accordance with the rules prescribed by paragraphs (1), (2), (3), (5), and (6) of section 503(a), except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants.

U.S. GOVERNMENT PRINTING OFFICE: 1962

IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 476

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v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

REPLY TO BRIEF FOR THE RESPONDENT

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COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

REPLY TO BRIEF FOR THE RESPONDENT

The petition for certiorari rests on two grounds for granting the writ. The respondent agrees that the petition should be granted with respect to the first ground.

The respondent opposes the grant with respect to the second ground because it allegedly presents a mere question of fact. However, no such question is involved here. The Second Circuit expressly recognized, as did Judge Kern who heard the testimony, that the evidentiary facts are not in dispute. (Pet. 12.) The issue,

rather, is whether the court below applied the correct standard of judgment. Such a question is clearly a question of law. See *Powers* v. *Commissioner,* 312 U.S. 259, 260 (1941). In the words of this Court, "There is no significant dispute as to the basic facts pertinent to the decision. We are thus not confronted here with the provision of Fed. Rules Civ. Proc. 52(a), that findings of fact shall not be set aside unless clearly erroneous." *United States* v. *du Pont de Nemours & Co.,* 353 U.S. 586, 598 (1957). See also *United States* v. *Mississippi Valley Generating Co.,* 364 U.S. 520, 526 (1961).

The taxpayers contend that the court below arbitrarily applied objective tests of liability instead of the subjective standard fixed by Congress. While the court purported to apply a subjective standard, the stated reasons for its conclusion have little to do with that standard. A decision which rests on irrelevant considerations is necessarily erroneous as a matter of law. See *Dickinson* v. *United States,* 346 U. S. 389, 395-397 (1953). And, as we have noted, the problem raised by the error here extends well beyond the present case. (Pet. 18.)

The respondent's request for a limited grant of certiorari would artificially isolate what are interrelated issues of statutory construction. Under section 117(m) a corporation is collapsible only if it was used for the construction of property "with a view to" the realization of a capital gain attributable to the property. In *United States* v. *Ivey,* 294 F. 2d 799 (1961), *rehearing denied,* 303 F. 2d 109 (1962), the Fifth Circuit has held that the statute applies only to a gain which would have been realized as ordinary income if the enterprise had been individually owned. Unless a

corporation was used in order to convert such ordinary income into capital gain, it follows that the stockholders lacked the requisite "view" or purpose proscribed by the statute.* The "view" and the contemplated gain, then, are integral elements of one over-all rule of law created by the statute. Moreover, the two grounds on which the petition rests involve common considerations. For example, the same undisputed facts which establish that the taxpayers held rental properties as long-term investments (Pet. 2-3) also indicate that Oakland Gardens was similarly built with the same purpose. Indeed, the respondent evidently concedes that the taxpayers "would have been entitled to capital-gains treatment had they conducted the enterprise in their individual capacities without utilizing a corporation." (Resp. 2.)

In short, to divorce one question from the other is to fragmentize the unified scheme of the statute and the disposition of intertwined issues.

Respectfully submitted,

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Attorneys for Petitioners

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* According to the respondent, the taxpayers are arguing "that Section 117(m)'s prescription of ordinary-income treatment is inapplicable here even if the corporation was, as the courts below found, 'collapsible.'" (Resp. 3.) This is not a correct statement of the taxpayers' position. They contend that a corporation is *not* collapsible, and hence Section 117(m) does not prescribe "ordinary income treatment," unless the realized profit constitutes ordinary income converted into capital gain.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 476

BENJAMIN BRAUNSTEIN and DIANA BRAUNSTEIN; Estate of Benjamin Neisloss, Deceased, JULIA NEISLOSS and RUSSELL NEISLOSS, Executors, and JULIA NEISLOSS; HARRY NEISLOSS and LILLIAN NEISLOSS, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF FOR PETITIONERS

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IN THE

Supreme Court of the United States

October Term, 1962

No. 476

Benjamin Braunstein and Diana Braunstein; Estate of Benjamin Neisloss, Deceased, Julia Neisloss and Russell Neisloss, Executors, and Julia Neisloss; Harry Neisloss and Lillian Neisloss, *Petitioners*,

v.

Commissioner of Internal Revenue, *Respondent*.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF FOR PETITIONERS

OPINIONS BELOW

The opinion of the Tax Court, the trial judge dissenting (A. 184-281),[1] is reported in 36 T.C. 22 (1961). The opinion of the Court of Appeals (R. 21-39) is reported in 305 F. 2d 949.

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[1] "A" refers to the record filed in this Court on the petition for certiorari. It is stipulated that either of the parties may refer to portions of that record.

JURISDICTION

The judgments of the Court of Appeals were entered on July 6, 1962. (R. 39-41.) The petition for a writ of certiorari was filed on October 1, 1962, and granted on December 10, 1962. (R. 42.) The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

QUESTION PRESENTED

Section 117(m) of the Internal Revenue Code of 1939 provides that gain from the sale or exchange of stock in a collapsible corporation is taxable as ordinary income rather than capital gain. The question presented is whether the section applies where the stockholders would have been entitled to capital gain treatment if they had conducted the enterprise in their individual capacities.

STATUTES INVOLVED

The pertinent statutes appear in the Appendix, *infra*, pp. 1a-4a.*

STATEMENT

Benjamin Braunstein and Diana Braunstein, and Harry Neisloss and Lillian Neisloss are, respectively, husband and wife. (R. 16.) Benjamin Neisloss and Julia Neisloss were husband and wife before his death on February 4, 1960. (R. 16, 22.) Each couple filed a joint income tax return for the calendar year 1950. (R. 16.) The husbands are hereinafter referred to as the petitioners.

Benjamin and Harry Neisloss were brothers. (R. 17.) From 1919 on they were engaged in holding and managing investments in real estate. (R. 17.) Benjamin Braunstein is an architect who became associated with them about 1930. (R. 17.)

In the 1920's the Neislosses acquired and improved commercial properties, and purchased parcels of land for development. The various holdings were owned and managed through corporations. (R. 5-7, 17.) In the 1930's the Neislosses organized a corporation which built and operated commercial properties, and another which built and operated a garden-type apartment development. They held their stock in these ventures for about 10 and 15 years, respectively. (R. 7, 9, 17.) In 1938 the Neislosses and Braunstein constructed a large apartment house through a corporation. The corporation sold the property in 1941 and was dissolved. (R. 17.) The profit on the sale was reported as a corporate gain. (R. 9.)

~~Between 1943 and 1948 the petitioners organized~~ five corporations which constructed multiple dwelling projects financed under section 608 of the National Housing Act. (R. 17.) The petitioners were equal stockholders in each corporation. (R. 17.) All five projects consisted of garden-type apartments. (R. 11-12, 17.) The projects and their dates of completion were as follows (R. 2, 18):

Projects	Dates of Completion
Somerset Homes, Inc.	March 1, 1943
Somerville Gardens, Inc.	September 1, 1943
Madison Gardens, Inc.	February 1, 1944
Monroe Gardens, Inc.	November 1, 1945
Brookside Gardens, Inc.	January 1, 1948

On November 30, 1949, the petitioners sold their stock in Monroe Gardens because they received a very good offer. (R. 2, 12, 18.) They had not been looking for a purchaser. The sale was solicited by a broker on behalf of the buyer. (R. 13, 18.) The petitioners

reported their profit on the sale as a capital gain, and the Commissioner did not question this treatment. (R. 13-18.) Throughout 1950 the petitioners continued to own their stock in the other four FHA projects completed in 1943, 1944, and early 1948. (R. 18.)

This case involves another FHA rental development known as Oakland Gardens. On March 31, 1948, the petitioners organized two corporations to build and operate Oakland Gardens. The corporations were Springfield Development Co., Inc. and Hill Development Co., Inc., hereinafter referred to as Springfield and Hill. (R. 26.) Two corporations were formed, rather than one, because section 608(b)(3) of the National Housing Act, 12 U.S.C. § 1743(b)(3) (1952), barred loans beyond $5 million to any one mortgagor. (R. 22.) The insured loans to the two corporations totalled $6,101,600. (R. 26.) Each petitioner owned one-third of the common stock in both corporations. (R. 26.) The petitioners' shares were not stock in trade or property of a kind includible in inventory. Nor did the petitioners hold their shares for sale to customers in the ordinary course of trade or business. (R. 19.) The FHA acquired 100 shares of preferred stock in each corporation pursuant to its rules and regulations. (R. 26.)

Construction started in April, 1948, and the buildings were completed between September, 1948, and June, 1949. (R. 26.) The eventual costs of construction were less than the FHA had estimated. (R. 26-27.) The mortgage loans of $6,101,600 exceeded the costs by $159,757.75. (R. 1-2, 27.)

Both the petitioners and the FHA made careful financial analyses of the development before it was built. (R. 28.) These studies indicated that the de-

velopment would be self-liquidating, *i.e.*, that the revenues would be sufficient to amortize the mortgage loans and pay interest, while providing a satisfactory return. The FHA estimated that the annual return after debt servicing would be about $78,000. The petitioners counted on a return of $45,000. (R. 28.)

The estimates of the petitioners and the FHA were based on assumed vacancies of 7% for apartments and garages. (R. 31.) However, between January and May, 1950, the vacancy rate was high, resulting in a rental loss of $16,000 on an annual basis. The development was also unexpectedly burdened by expenses of about $10,000 for removing garbage and rubbish, and another $10,000 for increased costs of redecorating. In addition, the development faced a rise of $30,000 in real estate taxes, and a further cost of $31,000 for free utilities to tenants in order to compete with neighboring projects. (R. 29-31.)

In the latter part of May, 1950, the petitioners were approached by brokers on behalf of two prospective purchasers. (R. 32.) On June 8, 1950, the petitioners entered into an agreement to sell their stock in Springfield and Hill. (R. 32.) The closing was scheduled for not later than September 30th. (R. 18.) At the insistence of the buyers, who did not want to pay for the cash held by the corporations, Springfield and Hill distributed $550,000 to the petitioners. The distributions were made as part of the sale transaction. (R. 22, 32; A. 244.) Neither corporation had any accumulated earnings or profits at the time of the distributions, or any earnings or profits for its taxable year in which the distributions were made. (R. 32-33.)

The sale was not completed in September because one of the buyers refused to go through with the pur-

chase. (R. 18.) After still further delays by the buyers, the sale was consummated on November 13, 1950. (R. 19, 32.) The sales price, as finally adjusted, was $399,702. (R. 33.) The two corporations continued to own the development and provided utilities free to their tenants. (R. 18.)

The petitioners remained active in the operation of rental properties held as long-term investments. They continued to hold their stock in four other FHA projects completed in 1943, 1944, and early 1948. See p. 3, *supra*. The stock in all four was sold in May, 1953, in one transaction. The sale was solicited by brokers acting on behalf of the buyers. (R. 12, 18.) In 1952 the petitioners, in their individual capacities, built a shopping center which they still owned at the time of trial in 1957. (R. 15, 19.) In 1955 they organized a corporation which built a large apartment house. The corporation still owned the building at the time of trial. (R. 15.) In 1956 they remodeled apartments and built stores on property which they had held for about ten years. (R. 15, 19.)

Each petitioner reported his gain attributable to the sale as long-term capital gain. (R. 33.) The Commissioner determined that the gains were taxable as ordinary income on the ground that Springfield and Hill were collapsible corporations within section 117(m) of the 1939 Code. The Tax Court sustained his determination. Judge Kern, the trial judge, dissented. (R. 23-24.) The Court of Appeals affirmed the decision of the Tax Court. (R. 21-39.)

The petitioners argued in the Court of Appeals that the corporations were not collapsible because they were not used as a means of converting ordinary income into

capital gain. The petitioners further contended that the corporations were not collapsible because the project was not built with a view to a quick sale. In this connection they asserted that the sale was unexpectedly due to the loss of rental income, and increased costs and taxes.[2] The Court of Appeals resolved both issues against the petitioners. In regard to the first, the court held that the corporations were collapsible even though the petitioners would have realized capital gains if they had owned the property individually. In regard to the second, the court agreed with the petitioners that in May, 1950, the vacancies were excessive and the vacancy rate was high. (R. 31.) Nor did it dispute the increased taxes, and the additional costs of redecorating, garbage and rubbish removal, and free utilities to tenants. (R. 29-31.) However, the court concluded that the sale was not due to these adverse developments, but had been previously contemplated during construction. This determination rested essentially on the ground that the admitted loss from vacancies and the heavier costs of redecorating could not be considered cumulatively with the additional burden of providing free utilities. (R. 31.). See further Pet. for Writ of Cert., pp. 11-18.

This Court granted the petition for certiorari, limited to a review of the question whether section 117(m) applies "in circumstances where the stockholders would have been entitled to capital-gains treatment had they conducted the enterprise in their individual capacities

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[2] The petitioners also argued that even if the corporations were collapsible, the profit realized by them was not taxable as ordinary income because less than 70 percent of the profit was gain attributable to the constructed property. See Int. Rev. Code of 1939, § 117(m)(3).

without utilizing a corporation." (R. 42.) The Fifth Circuit has resolved the same question in favor of the taxpayer, in an opinion written by Judge Wisdom and concurred in by Judges Rives and Cameron. *United States* v. *Ivey*, 294 F. 2d 799 (1961), *rehearing denied*, 303 F. 2d 109 (1962).[3]

SUMMARY OF ARGUMENT

The gains realized by the petitioners through the sale are taxable as long-term capital gains unless section 117(m) applies. Section 117(m) provides that gain from the sale or exchange of stock in a collapsible corporation is taxable as ordinary income. A collapsible corporation is defined as a corporation formed or used principally for constructing property with a view to the shareholders' realization of "gain attributable to such property" before the corporation realizes a substantial part of the net income to be derived from the property. The "gain attributable to such property," within the meaning of the statute, is profit which constitutes a conversion of ordinary income into capital gain through the use of the corporation. Springfield and Hill were not collapsible corporations because there was no such conversion here. As the court below recognized, the profit realized here would have been capital gain if the petitioners had individually owned and operated the development.

Section 117(m) is a subsidiary statute in a comprehensive legislative scheme dealing with the treatment of capital gains and losses. That scheme provides the framework within which section 117(m) appropriately applies. The basic provisions on capital gains are sub-

[3] Judge Cameron dissented in favor of the taxpayer with respect to another issue in the case.

sections (a) and (c) of section 117, as amplified by subsection (j) of the same section. Under these provisions long-term capital gains are taxed at a lower rate than other income. A long-term capital gain is a gain realized on a sale or exchange of "property" held for over 6 months, including real property and depreciable property used in a trade or business—excluding stock in trade, property includible in inventory, and property held primarily for sale to customers in the ordinary course of trade or business. The purpose of these interrelated provisions is to relieve taxpayers from excessive tax burdens on the conversion of capital investments or the realization of capital appreciation, and to remove the deterrent effects of any such burdens. Over the years the Court has closely construed the provisions in response to this controlling purpose. Hence the Court has consistently refused to apply them to a gain which is essentially profit from the everyday operation of a business or a substitute for what would otherwise be received as ordinary income. In short, a taxpayer cannot convert ordinary income into capital gain under cover of a sale or exchange of "property".

Section 117(m) is a further evolution of the same basic principle, and is to be construed accordingly. Like the decisions of this Court, it is solely concerned with attempts to convert ordinary income into capital gain.

I.

The meaning of "gain attributable to such property" is fully revealed by the legislative history of section 117(m). This legislative history consists of a tax message by the President, testimony by the Secretary

of the Treasury and the General Counsel of the Treasury in hearings before the Ways and Means Committee, a Joint Memorandum prepared by the Treasury and the Staff of the Joint Committee on Internal Revenue Taxation, reports of the Ways and Means Committee and the Finance Committee, and an additional Summary by the Staff of the Joint Committee. As this illuminating history shows, "gain attributable to such property" is profit which would otherwise constitute ordinary income if the corporation had realized it in the ordinary course of business or if the enterprise had been individually owned and operated.

By the same token, Springfield and Hill were not collapsible corporations. For they were not used as a means of realizing the gain contemplated by the statute. The development was property used in a trade or business. If the corporations had directly sold the development, the profit would have been a capital gain. If the petitioners had directly owned and sold the development, the profit would also have been a capital gain. The sale of the stock instead of the assets simply produced a similar capital gain. At the same time the corporations continued to realize the ordinary income from the property as ordinary income. Since the gain was not a disguised realization of ordinary income from the constructed property, it was not "gain attributable to such property" within the meaning of section 117(m).

The decision below has perverted section 117(m) by converting capital gain into ordinary income. The statute has been turned into a penal levy. Taxpayers who have not engaged in any tax avoidance are punished for having held property through a corporation rather than as individuals.

II.

The Court of Appeals rejected our interpretation of the statute on the ground that it was contrary to the "literal" meaning of the statute. The court's resort to "literalism" consists of two errors—quite apart from the absurdity of the result. First, the court gratuitously assumed that gain attributable to the constructed property, as contemplated by the statute, "literally" means only what the court thought it meant. Second, even if this "literal" assumption were correct, the court egregiously erred in ignoring the plain-spoken purpose and policy of section 117(m).

The Court of Appeals' reliance on the "literal" meaning is merely obvious question-begging. It simply assumes what it supposedly seeks to establish—that the words in question necessarily have only one meaning, regardless of their particular context or purpose. As this Court has repeatedly held, in regard to tax statutes as well as other statutes, the meaning of words is shaped by the setting in which they are used. The same word or phrase has diverse meanings in diverse contexts. The content given to words should accordingly conform to the sense in which they are used. This settled principle of construction is all the more significant where the application of a statute turns on such a protean concept as gain. Hence, no matter how "clear" a statute may seem on a hasty reading or superficial examination, nothing precludes the use of legislative materials in aid of its construction.

The question here is not what the words in issue may mean as an abstract matter. The question is what they mean as concretely used in section 117(m). And that meaning is unmistakably disclosed in the authoritative

pronouncements made in the hearings and the committee reports. There is no question of doing violence to the "literal" language of the statute. For here we are considering a flexible phrase whose connotation depends on the context in which it appears. The Court of Appeals read the words involved in isolation from their special setting. The net result is that it reached an apparently senseless conclusion. Under the decision below a statute designed to prevent the conversion of ordinary income into capital gain has just the opposite effect of converting capital gain into ordinary income.

The correct answer is the same even if the phrase "gain attributable to such property" means "literally" what the Court of Appeals imputed to it. This Court has definitively disapproved a dogma of "literal" interpretation which confines itself to the bare words of a statute. To construe a statute is to ascertain its meaning, and that meaning is to be determined in the light of its history and purpose. Therefore, regardless of how "plain" the words may be, the Court will not read them so as to produce absurd, harsh, or incongruous results. Even when the bare words do not entail an absurd result, but an unreasonable one at variance with the policy of the legislation as a whole, the Court refuses to sacrifice common sense. Whenever possible, a statute should be given a sensible construction, consistent with the legislative purpose.

This principle is repeatedly applied in taxation—particularly in regard to section 117(a). Various gains have been denied capital gain treatment in accordance with legislative history and policy, though the statutory language, abstractly considered, is broad enough to encompass such gains. What is true of section 117

(a) is necessarily just as true of section 117(m). For subsection (m) is merely a policing provision designed to safeguard the policy expressed in subsection (a). The common purpose of both is to maintain a line between profits from the everyday operation of a business and profits from appreciation accrued over a period of time. Since subsection (a) makes no attempt to tax profits from appreciation as ordinary income, no purpose to do so can be attributed to subsection (m). The Government itself has refused to construe subsection (m) in "literal" fashion, where the result would have extended the statute beyond its intended purpose.

If section 117(m) is applied here on the pretext of "literalness", the result will be harsh and incongruous, as well as plainly absurd. It will squarely contradict the result clearly contemplated by Congress. Instead of preventing the conversion of ordinary income into capital gain, the Commissioner will harshly penalize the petitioners by converting capital gain into ordinary income. They will be severely punished merely because they owned the property through corporations rather than as individuals. The court below expressly conceded that its "literal" reading of the statute "produces unwarranted taxation of capital gains as ordinary income." (R. 36.) Or, as the Fifth Circuit concluded in *United States v. Ivey, supra,* at 803, the Commissioner's construction "would make nonsense of the statute." Neither the hearings nor the reports reveal the slightest desire to enact such novel legislation which would tax, as ordinary income, profits that are normally realized as capital gains.

III.

Our position is cogently confirmed by the scheme and structure of section 117(m). The phrase "gain attributable to such property" does not stand alone, but gathers meaning from the words around it.

A corporation is collapsible only if it is formed or used principally for construction "with a view to" the shareholders' realization of the gain attributable to the property. The required "view" and the gain are interrelated elements of one over-all rule of law created by the statute. The phrase "with a view to" predicates liability on a particular purpose—the purpose to obtain the gain proscribed by the statute. A corporation is collapsible, then, only if used for construction as a calculated means of realizing that benefit. The pronounced emphasis on purpose or motive is designed to make sure that the statute is closely confined to corporations that are intentionally used to secure that gain. Therefore, that gain must be some special advantage not obtainable in normal fashion by the corporation itself or by the shareholders as direct owners of the enterprise. And that advantage or gain can only be profit that constitutes an attempted conversion of ordinary income into capital gain. Otherwise the emphasis on purpose or motive makes little sense. For the statute is then read as saying that a corporation is collapsible if it is calculatedly used as a means of realizing a capital gain which is otherwise normally realized as a capital gain.

Another part of the statute—clause (i) of section 117(m)(2)(A)—is equally revealing. Under that clause a corporation, if it is to be deemed collapsible, must be formed or used for construction with a view

to a sale or exchange of its stock before the corporation itself realizes "a substantial part of the net income to be derived from the property." This "net income" is the normal profit to be derived from the property in the ordinary course of the business. The statute is applied in relation to the amount of such "net income" in order to compel the corporate realization of substantial profit taxable at ordinary rates. But this concern with ordinary income at the corporate level is pointless unless the gain proscribed at the stockholder level constitutes such ordinary income converted into capital gain.

Still another portion of the statute sheds further light in support of our conclusion. Paragraph (1) of section 117(m) provides that gain realized on a sale of stock in a collapsible corporation is taxable as ordinary income. The gain is treated as ordinary income in order to compensate for the fact that the same gain would normally be realized and taxed as ordinary income. Therefore, once more it necessarily follows—if the statute is to be sensibly read—that the gain attributable to the property is gain which constitutes a conversion of ordinary business profit.

All these additional considerations converge to the same conclusion that Springfield and Hill were not collapsible corporations.

IV.

Apart from its "literal" construction, the Court of Appeals sought to sustain the deficiencies on the further ground that section 117(m) was meant to apply to "some cases when the asset if sold by the taxpayer would have produced capital gain." (R. 37.) How-

ever, these are all cases where ordinary income, consisting of rents, is converted into capital gain through a liquidation of a corporation. The court erroneously reasoned that if the statute may apply to a profit realized in the case of a liquidation, then it necessarily applies to a profit realized in the case of a sale of stock. As the Court of Appeals read the statute, it is wholly immaterial that the profits from the sale and from the liquidation are distinctly different in kind.

In order to reach every kind of converted ordinary income, the draftsmen of the statute covered both liquidations of corporations and sales of stock. The one and only purpose was to prevent conversions in each and every case, regardless of which method was used. But it does not in the least follow, as the court below inferred, that because the statute may apply to a liquidation relating to property held for rental, it *ipso facto* applies to a sale of stock. The relevant inquiry is not whether a sale should be treated like a liquidation, but whether a stockholder is enabled to realize the gain proscribed by the statute—the gain that Congress intended to tax as disguised ordinary income. Our conclusion in this respect is confirmed by the committee reports. Whether the profit is realized through a liquidation or a sale of stock, the application of section 117 (m) turns on the nature or content of the profit—just as it does when section 117(a) is involved. The fact that a liquidation may produce the precise gain contemplated by Congress is no reason for penalizing a sale which, by the Court of Appeals' own admission, has not produced any such gain.

In the end the Court of Appeals falls back once more on its "literal" reading of the statute. At the same time it rather frankly concedes that it has not in-

terpreted the words of section 117(m) "in light of their purposes in order to carry out Congressional intent." (R. 38-39.) The Court of Appeals attempts to justify the mutilation of legislative policy by citing this Court's opinion in *Hanover Bank* v. *Commissioner*, 369 U.S. 672 (1962). However, the Court of Appeals has clearly misconstrued the *Hanover Bank* decision—which reversed the same Court of Appeals.

V.

As a final ground for its conclusion, the Court of Appeals refers to a statute enacted eight years after the taxable year involved here. This later statute is section 341(e) of the 1954 Code, an amendment added by section 20 of the Technical Changes Act of 1958. The Court of Appeals has seriously misconstrued this later action of Congress—even if, for the moment, it is deemed otherwise relevant here. The 1958 amendment and its legislative history confirm that the Treasury has harshly misapplied section 117(m). Moreover, the court's attempted reliance on the 1958 amendment directly contravenes the amendment itself and its authoritative committee report. Even if the amendment, on some theory, were possibly relevant as a retroactive gloss on section 341 of the 1954 Code, it cannot affect section 117(m) of the 1939 Code.

In any event—quite apart from the special considerations involved here—the 1958 amendment and the related committee report cannot cast any retroactive implications in the Commissioner's favor. Later legislative history is not relevant evidence of what a prior statute means. The obligations of a taxpayer for a particular year stem from the statutes passed by Congress for that year. Nothing that was said in 1958 can

change the legislative purpose and policy expressed in 1950. The Commissioner's position is no better insofar as the amendment itself is concerned. A later statute sheds no light on what an earlier Congress contemplated or intended. It cannot give a statute enacted earlier a different meaning from what it then acquired.

VI.

The Commissioner's position in this case raises a basic issue which goes to the very essence of tax administration in our democratic society. May the Treasury disregard legislative hearings and committee reports which clearly disclose the intended meaning and scope of tax legislation entrusted to its fair administration? May it close its eyes and ears to the plainly expressed policy of a statute and proceed to improvise a policy of its own? These questions involve no less than the integrity of the administrative process in our tax system. This case unhappily reveals the kind of administration which raises such questions. For we have here a steadfast refusal to pay attention to an unmistakable legislative purpose—a purpose to which the Treasury itself significantly contributed. It would, indeed, be a sad reflection on our tax system and the Treasury if taxpayers could not rely on a unanimous expression of views voiced by the President, the Secretary of the Treasury, the General Counsel of the Treasury, the House Ways and Means Committee, the Senate Finance Committee, and the Staff of the Joint Committee on Internal Revenue Taxation. The position now taken by the Government is completely at odds with all these official statements on the statute.

Published hearings and reports are meant to be read and studied by taxpayers and their advisers. Today they are well-nigh indispensable as an important source of reasonable expectations. They are a significant means of providing a fair measure of certainty to which taxpayers are surely entitled. If the Treasury may disregard relevant hearings and reports, then they are essentially delusive snares laid for taxpayers and their advisers. The Treasury would ignore not only the message of the President and the reports of both tax committees, but also its own repeated assurances on the precise reach of the statute—assurances given by the head of the Treasury and another high-ranking official. It was on the basis of these repeated assurances, given after full consideration of the evils involved, that Congress acted. The Treasury should not be allowed to slight committee reports and its considered assurances before tax committees. In these days of high rates, it is all the more urgent that the Treasury be obliged to abide by its professions and assurances. At the very least a fair and objective execution of the tax laws requires the Government to keep faith with Congress and those to whom Congress has addressed its laws.

Here the Treasury's change of position does not even have the excuse of improving the statute. Whatever the differences between the Second and Fifth Circuits, they both agree on one thing—that the tax asserted here produces an unreasonable result. The Second Circuit calls it "unwarranted"; the Fifth Circuit, "nonsense."

ARGUMENT

THE GAINS REALIZED BY THE PETITIONERS ARE NOT TAXABLE AS ORDINARY INCOME UNDER SECTION 117(m) OF THE INTERNAL REVENUE CODE OF 1939

The gains realized by the petitioners through the sale are taxable as long-term capital gains unless section 117(m) applies. Int. Rev. Code of 1939, §§ 115(d), 117(a)-(c). Section 117(m) was enacted in 1950. Revenue Act of 1950, § 212(a). It is a special statute directed against certain schemes in tax avoidance—the use of so-called collapsible corporations. The statute consists of three paragraphs. The first prescribes the tax treatment of gain realized by a stockholder in a collapsible corporation. The second defines the special nature of a collapsible corporation. The third limits the application of section 117(m) though the corporation is otherwise collapsible. For present purposes we are primarily concerned with paragraphs (1) and (2).

Paragraph (1) generally provides that gain "from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation" is taxable as **ordinary income if, in the absence of section 117(m),** the gain would qualify as a long-term capital gain. Paragraph (2) defines a collapsible corporation as:

> "a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—
>
> "(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from the property, and

"(ii) the realization by such shareholders of gain attributable to such property."[4]

A collapsible corporation, then, is a very special kind of entity. It is a corporation which was formed or used principally for construction with a view to achieving two results. One intended result is "the sale or exchange of stock by its shareholders" or "a distribution to its shareholders" before the corporation realizes "a substantial part of the net income to be derived from" the constructed property. The other intended result is "the realization" by the shareholders of "gain attributable to such property." A corporation is not collapsible unless both requirements are met.

The question before the Court turns on the meaning of the second requirement. We contend that Springfield and Hill were not collapsible corporations because the development was not built as a means of having the shareholders realize, within the meaning of the statute, "gain attributable to such property." In our view, "gain attributable to such property" is profit which constitutes a conversion of ordinary income into capital gain through the use of the corporation. In other words, the second requirement is not met where the profit would have been capital gain if the stockholders had held the property directly rather than through a corporation. As the court below recognized, the profit realized here would have been capital gain if the petitioners had individually owned and operated the development. See further pp. 68-69, *infra*.

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[4] We are quoting the statute as it stood in 1950—the year before the Court. In 1951 the definition was expanded to include corporations acquiring certain properties through purchase. Revenue Act of 1951, § 326.

Section 117(m) is a subsidiary statute in a comprehensive legislative scheme dealing with the treatment of capital gains and losses. Therefore, that scheme necessarily provides the framework for our analysis. For "the meaning of a statute is to be looked for, not in any single section, but in all the parts together and in their relation to the end in view." Cardozo, J., in *Panama Refining Co.* v. *Ryan*, 293 U.S. 388, 439 (1935). See also *Jarecki* v. *Searle & Co.*, 367 U.S. 303, 307-308 (1961); *Richards* v. *United States*, 369 U.S. 1, 11 (1962).

The tax structure of capital gains and losses rests essentially on section 117(a) and (c). Subsection (c) provides that long-term capital gains are subject to a lesser tax than other income. Moreover, the tax on such gains is limited to 25 percent of the gains. Subsection (a) defines a long-term capital gain as "gain from the sale or exchange of a capital asset held for more than 6 months." The term "capital assets" is, in turn, defined as "property held by the taxpayer (whether or not connected with his trade or business)" —subject to various exclusions. Among these exclusions are stock in trade, property includible in inventory, property held primarily for sale to customers in the ordinary course of trade or business, and depreciable property and real property used in a trade or business. The definition of "capital assets" is significantly amplified by section 117(j), which states that gain realized on a sale or exchange of "property used in the trade or business" is taxable as gain from a sale or exchange of capital assets held for more than 6 months. The term "property used in the trade or business" means depreciable property and real property used in a trade or business, "held for more than 6

months"—excluding, once more, stock in trade, property includible in inventory, and property held primarily for sale to customers in the ordinary course of trade or business.

The purpose of these interrelated provisions is "to relieve" taxpayers from "excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." *Burnet* v. *Harmel*, 287 U.S. 103, 106 (1932). Hence over the years the Court has closely construed the provisions in response to this controlling purpose. As the Court recently stated, "While a capital asset is defined in § 117(a)(1) as 'property held by the taxpayer,' it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset. This Court has long held that the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year." *Commissioner* v. *Gillette Motor Transport*, 364 U.S. 130, 134 (1960).

The Court formulated this basic principle of construction at the very outset, and has consistently applied it ever since. In *Burnet* v. *Harmel*, *supra*, it held that a lessor's receipts under oil and gas leases are taxable as ordinary income, though operations under such leases entail the transfer of ownership from the lessor to the lessee. After carefully reviewing the relevant legislative history and policy, the Court concluded that the treatment of the receipts as ordinary income "does

not ordinarily produce the kind of hardship aimed at by the capital gains provision of the taxing act." Profits from oil and gas operations are essentially the same as profits regularly realized in a manufacturing enterprise. Their taxation as ordinary income "does not act as a deterrent upon conversion of capital assets." 287 U.S. at 106.

The later decisions of the Court have equally implemented the purpose underlying the capital gain statutes. A lump sum received by a lessor, as consideration for cancelling a lease, is taxable as ordinary income. *Hort* v. *Commissioner*, 313 U.S. 28 (1941). Even though a lease is "property" for various purposes, a payment for its termination is "not a return of capital." The payment is "merely a substitute for the rent reserved in the lease." A cancellation of a lease involves "nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises." *Id.* at 31-32. Similarly, transactions in corn futures, integrally related to the taxpayer's manufacturing business, are not sales of capital assets. *Corn Products Co.* v. *Commissioner*, 350 U.S. 46 (1956). "Admittedly," the Court stated, such futures do not "come within the literal language of the exclusions set out" in section 117(a). Nevertheless they are not capital assets, because the statute "must not be so broadly applied as to defeat rather than further the purpose of Congress." *Id.* at 51-52. "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by § 117 applies to transactions in property which are not the normal source of business income." *Id.* at 52.

More recently the Court held that an amount received on a sale of an oil payment right is not a capital gain, though the right is an interest in land. *Commissioner v. Lake*, 356 U.S. 260 (1958). "We do not see here," the Court stated, "any conversion of a capital investment. The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income." "The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property." *Id.* at 265-266. The same conclusion was reached where the Government compensated a motor carrier for a temporary taking of its facilities. *Commissioner v. Gillette Motor Transport, supra.* The payment was recompense for use, "which is commonly regarded as rent." The right appropriated was "only the right to determine the use to which those facilities were to be put." It makes no difference that such a right is concededly "property" in the ordinary sense. The right to use is "manifestly not of the type which gave rise to the hardship of the realization in one year of an advance in value over cost built up in several years, which is what Congress sought to ameliorate by the capital-gains provisions." 364 U.S. 130, 134-136 (1960).

All these decisions are variations on the same basic theme. The special treatment of capital gains in section 117 applies only to "gains resulting from a conversion of capital investments," or "an increase in the value of the income-producing property." It does not

apply to profits from "the everyday operation of a business"; transactions which are "the normal source of business income"; or "a substitute for what would otherwise be received at a future time as ordinary income." In short, a taxpayer cannot convert ordinary income into capital gain under cover of a sale or exchange of "property". The taxpayer is simply converting future income into present income.

Section 117(m) is a further variation on the same significant theme. Like the decisions of this Court, it is concerned with attempts to convert ordinary business profit into capital gain. It is a policing provision designed to cope, in a certain area, with the perennial problem which this Court has resolved on a case-by-case basis under section 117, as illuminated by its history and purpose. To borrow the words of Mr. Justice Cardozo, the successive revenue acts reflect the Government's repeated efforts to thwart taxpayers who would escape from a large tax on ordinary income to a smaller tax on capital gains. See, *e.g.*, Int. Rev. Code of 1939, §§ 115(g), 117(l), (o). "At times escape has been blocked by the resources of the judicial process." Section 117(m) is another chapter in the same recurring endeavor to prevent the conversion of ordinary income into capital gain. Cf. *Burnet* v. *Wells*, 289 U.S. 673, 675-677 (1933).[5]

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[5] Cf. *Massey Motors* v. *United States*, 364 U.S. 92, 97 (1960), involving efforts to convert ordinary income into capital gain through depreciation deductions. And see further Int. Rev. Code of 1954, § 1245, added by Revenue Act of 1962, § 13(a), 76 Stat. 1032.

I. The Corporations Were Not Collapsible Because They Were Not Used as a Means of Realizing a Gain Constituting a Conversion of Ordinary Income Into Capital Gain

We now turn to the precise particulars of the present dispute. As we have indicated, the controversy turns on the meaning of the phrase "gain attributable to such property," as used in section 117(m). The meaning of these words is scarcely obscure. Before the statute was enacted, Congress and the Treasury amply disclosed what they had in mind. Unlike other disputes over tax statutes (cf. *United States* v. *Benedict*, 338 U.S. 692 (1950)), we are "dealing here with a situation where the meaning of statutory language is resolved by reference to explicit statements of Congressional purpose." *Helvering* v. *Reynolds*, 313 U.S. 428, 431-432 (1941). See also *Colony, Inc.* v. *Commissioner*, 357 U.S. 28, 33 (1958); *Commissioner* v. *Bilder*, 369 U.S. 489, 502 (1962).

Section 117(m) derived from a recommendation made by the Treasury to Congress. On January 23, 1950, President Truman sent Congress a message proposing that it close various loopholes "to improve the fairness of the tax system." He specifically requested corrective legislation for certain "inequities." "Most of these," he emphasized, "permit individuals, by one device or another, to take unfair advantage of the difference between the tax rates on ordinary income and the lower tax rates on capital gains. As one example, under present law producers of motion pictures, and their star players, have attempted to avoid taxes by creating temporary corporations which are dissolved after making one film. By this device, their income from making the film, which ought to be taxed at the individual-income tax rates, would be taxed only at

the capital-gains rate. Thus, they might escape as much as two-thirds of the tax they should pay." *Hearings before the Committee on Ways and Means on Revenue Revision of 1950*, 81st Cong., 2d Sess. 2-5 (1950).

The President's message was followed by hearings before the Ways and Means Committee. The Committee approved his proposal to foreclose "this device", after extensive testimony by Treasury Secretary John W. Snyder and Treasury General Counsel Thomas J. Lynch. Their thoughtful analysis in aid of Congress sheds particularly cogent light on the purpose and scope of the statute.

Secretary Snyder referred to a list of "tax loopholes together with proposed remedies" which had been "developed jointly by the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation." The list was contained in a Joint Memorandum submitted to the Committee. "A number of these loopholes," the Secretary stated, "arise out of defects in the capital gains tax structure, which provides a maximum effective rate of 25 percent on gains from capital assets held for more than 6 months. The President, in his recent tax message to the Congress, gave an example of one of these loopholes, the 'collapsible' corporation, through which individuals, engaged in the business of producing certain types of property, have attempted to convert ordinary business and earned income into long-term capital gains." *Id.* at 20.

The Joint Memorandum reiterated the Administration's concern over "the loophole through which individuals, engaged in the production of certain types

of property, have attempted to convert their ordinary business income into the more favorably treated capital gains by means of corporate shells." The Memorandum then elaborated on this problem of conversion as follows:

"For example, if a motion-picture producer made all of his pictures as an individual, his entire gain from such operations would be taxed at individual rates which range as high as 82 percent. If he produced all of such films through a single corporation, the corporation would pay a tax of as high as 38 percent on the profits as realized, and the producer would pay an individual income tax as such profits are distributed by the corporation. Producers have tried to avoid these results by organizing separate corporations for each motion picture; upon completion of the film but prior to the realization of any income therefrom, the corporation is liquidated and the assets are distributed. In such a case, the corporation pays no tax, claiming that it has realized no income. The producer pays tax upon the difference between his cost and the fair market value of the assets so distributed; but such gain is reported as long-term capital gain with a maximum effective rate of 25 percent. After liquidation, the estimated value of the released production will be amortized against the income from the film as it is received. If the income from the film does not exceed its estimated value, there is no further tax. . . ." *Id.* at 70.

"Thus," the Memorandum pointed out, "the producer's profit from the picture, which would ordinarily be taxable first at the corporate rate and then at the individual income tax rate when received as dividends, has borne only a single 25-percent tax." The Memo-

randum then noted that this conversion of ordinary income into capital gain was not confined to the motion-picture industry:

"It is undersood that the tax-saving device of organizing and liquidating a corporation for the purpose of securing similar tax benefits is also being used to some extent in the building and construction trades. Individuals engaged in the building or construction business organize a corporation for each development project, not only for the purpose of limiting liabilities, but for the purpose of securing these benefits. The corporation is organized at the beginning of construction and is liquidated upon completion of the project and before any sales are made. If the corporation continued in existence and sold all the units itself, it would pay an ordinary income tax on the difference between the amount received for the units and the cost of construction.

"In order to secure tax benefits, the corporation is permitted to exist only until the construction is completed or for 6 months after its stock was issued, whichever date is the later, and upon liquidation the value of the units distributed is estimated at the amount for which it is expected the units will be sold. On this basis, the stockholders report as a long-term capital gain the difference between the net amount they expect to receive and the cost of the stock owned by them at the time of the liquidation. Having received the assets, the stockholders proceed to sell the assets and to report for tax purposes as an ordinary gain or loss the difference between the value at which the assets were acquired on the liquidation and the actual selling price." *Id.* at 70.

The Memorandum concluded: "It is recommended . . . that long-term capital-gains treatment be denied to any shareholder who sells or liquidates his securities in any corporation so utilized by him for such tax avoidance purposes." *Id.* at 71.[6]

General Counsel Lynch dwelt further on the precise problem which disturbed the Treasury—"the so-called collapsible corporations by means of which individual taxpayers seek to convert ordinary business income into long-term capital gains." And he reiterated the Treasury's desire to foreclose capital-gains treatment "to any shareholder who sells or liquidates his securities in any corporation so utilized by him for such tax-avoidance purposes." As in the Joint Memorandum, he specifically referred to builders who seek to convert into capital gain what would be ordinary income if the corporation sold the property itself. *Id.* at 137-138.

"In considering the remedy" for collapsible corporations, Mr. Lynch continued, it must be recognized "that most corporate enterprises are organized to do business and are designed to operate for profit. We do not propose any change in the present treatment applicable to the liquidation of such corporations." However, "where it appears that a corporation was organized or acquired by an individual or group of individuals to manufacture or produce property without any intention to operate the corporation in the

[6] See also *Hearings before the Committee on Finance on H.R. 8920*, 81st Cong., 2d Sess. 9 (1950), in which Secretary Snyder emphasized anew the Treasury's concern with "devices, such as the collapsible corporation," which "allow taxpayers unintended access to the more favorable rates of tax levied on long-term gains by permitting conversion of short-term gains or ordinary income into long-term gains."

normal manner or without a view toward realization of profits by such corporation, it is recommended that such shareholders be denied the favorable long-term capital-gains treatment which might now be applicable with respect to the sale or liquidation of their stock." *Id.* at 139.

A colloquy then occurred between Representative Mills, of the Committee, and Mr. Lynch. Representative Mills stated:

> "Mr. Lynch, let me see if I understand this problem. An individual will establish a corporation for the purpose of holding the assets, something he has created, some property that he created, such as a motion picture. When that purpose is served and he feels that the corporation is no longer needed, the corporation is liquidated and the assets will be in turn transferred to him or the others who own stock in the corporation.
>
> "During the time the corporation is in existence, no corporation income tax is paid, because no income is realized. When the assets are transferred from the corporation to the stockholders, the difference between the basis for the stock and the value of the assets is treated as capital gains rather than ordinary income for income-tax purposes, and thus the rate of tax is 25 percent."

Mr. Mills asked whether "that" was what the Treasury desired to have "corrected."

Mr. Lynch answered:

> "That is right. It is the fact that these corporations are designed specifically to receive no income, and the procedure is such that they receive no income. The purpose for which they are created to produce a product for trade, to produce a motion picture, that process is ordinarily truncated

at the point where there would be some income to the corporation so as to avoid the corporation tax." *Ibid.*

Mr. Lynch went on to indicate that this procedure enabled the stockholders to substitute a capital gains tax for the ordinary tax that the corporation would usually pay on business profits if the picture were released by the corporation in normal fashion. Mr. Mills then asked: "Do I understand now that it is the Treasury's suggestion that we legislate in such a way that the Treasury may have the opportunity of reviewing these situations, and if it appears that the device is used to evade tax payment, the Treasury may, instead of assessing the capital-gains rate, assess the regular income-tax rate on the individual?" Mr. Lynch replied, "That is right. The effect of it would be to view the corporation device as a mere sham, organized not for the purpose of carrying on business, but only for the particular purpose of carrying out what we would characterize as tax avoidance." *Id.* at 139-140.

Representative Jenkins, of the Committee, explored the Treasury's proposal in regard to the construction industry. "Suppose," he inquired, "there is a real-estate man, a plasterer and a lumberman and an electrician, a plumber and 2 or 3 more, say 10, who engaged in some construction work. Suppose they go to work and build a big addition. They buy the land cheap and they do the work economically and well. In other words, it is a money-making proposition. The 10 of them build 100 houses. If it is so simple as this, after they have done the work can they dissolve and apportion those homes out 10 to each one?" Mr. Lynch indicated that the case put by Mr. Jenkins was

"the type of device" with which the Treasury was concerned. *Id.* at 140-141.

Toward the end of his testimony Mr. Lynch stated that the Treasury opposed any corrective legislation which would endow it with "great discretion." The Treasury desired a "specific" statute, with "definite standards." It also wished "to be assured that the legislation" would "not place in jeopardy the normal liquidation of corporations, corporations which are organized and carried on regularly to conduct a business." Mr. Mills declared, "It should be clearly understood, then, that there is no purpose on the part of the Treasury to jeopardize the liquidation of corporations." Mr. Lynch answered, "Not those that are carried on in the traditional and regular way." In response to another question, he said, "We want the law to define what this is and not to leave it to the discretion of the Commissioner." *Id.* at 140-141.

The reports of the tax committees further delineate the design and scope of section 117(m). "The collapsible corporation," they state, "is a device whereby one or more individuals attempt to convert the profits from their participation in a project from income taxable at ordinary rates to long-term capital gain taxable only at a rate of 25 percent." They specifically note that "the term 'collapsible corporation' is so defined as to include corporations lending themselves" to this "attempted tax-saving practice." The reports focus initially on the movie industry in summarizing the evil at which the statute strikes. "A legitimate corporation engaged in the business of producing motion pictures would pay ordinarily the corporate income tax on its net income and its shareholders would pay ordinary income tax on their dividends from the corpora-

tion. Producers have tried to avoid these results by organizing separate corporations for each motion picture. Upon completion of the film but prior to the realization by the corporation of any income therefrom, the corporation is liquidated and the assets are distributed. In such a case, the corporation pays no tax, claiming that it has realized no income. The producer pays tax upon the difference between his cost and the fair market value of the assets so distributed; but such gain is reported as long-term capital gain with a maximum effective rate of 25 percent. After liquidation, the fair market value of the released production is ordinarily amortized against the income from the film as it is received. If the income from the film does not exceed such fair market value, there is no further tax." The same "device," the reports add, "has also been used in the building-construction trade by contractors who have corporations construct buildings for sale and then liquidate the corporations and sell the buildings as individuals." Finally, the reports state that section 117(m) applies to sales of stock as well as liquidations. "While the primary use made of collapsible corporations in the past has usually involved their liquidation in the manner" described, stockholders using "such a corporation could raise the same tax questions" through a sale of stock "at the time and under the circumstances when the corporation might otherwise be liquidated." H.R. Rep. No. 2319, 81st Cong., 2d Sess. 56-57, 97 (1950); Sen. Rep. No. 2375, 81st Cong., 2d Sess. 45, 89 (1950). See also Summary of H.R. 8920, "The Revenue Act of 1950," As Agreed to by the Conferees, Prepared by the Staff of the Joint Committee on Internal Revenue Taxation 17 (Sept. 1950).

In the light of the committee reports and the Treasury testimony, the meaning of "gain attributable to such property" readily emerges. The statute defines a collapsible corporation as a corporation used for construction with a view to the shareholders' realization of gain attributable to the constructed property before the corporation itself realizes a substantial part of the net income to be derived from the property. As the legislative history plainly shows, the "gain attributable to such property" is profit which would otherwise constitute ordinary income if the corporation had realized it in the ordinary course of business or if the enterprise had been individually owned and operated.

We fail to see how any other meaning can be imputed to the gain in question, unless the plain-spoken legislative history is to be completely ignored. The collapsible corporation is repeatedly described as "a device"—something which is deliberately contrived to achieve a certain result. That result is repeatedly condemned as an "inequity" and a "loophole". And the nature of the inequity and loophole is unmistakably identified. A collapsible corporation is a "device" designed "to take unfair advantage of the difference between the tax rates on ordinary income and the lower tax rates on capital gains"; a means whereby income "which ought to be taxed at the individual-income tax rates" is "taxed only at the capital-gains rate"; a "loophole" whereby individuals "have attempted to convert their ordinary business income into the more favorably treated capital gains"; a corporation enabling taxpayers to avoid paying either the ordinary individual rates or the regular corporate rate "on the profits" of their business operations; a "tax-saving device" used "for the purpose of securing"

such benefits; a "corporation so utilized" by a shareholder "for such tax avoidance purposes"; a "device" which allows "taxpayers unintended access to the more favorable rates of tax levied on long-term gains by permitting conversion of short-term gains or ordinary income into long-term gains"; a "means" whereby "individual taxpayers seek to convert ordinary business income into long-term capital gain"; a corporation organized "without a view toward realization of profits by such corporation" and designed "to avoid the corporation tax"; a corporation used to avoid "the corporate income tax" on net income and "ordinary income tax" on individual income; "a device whereby one or more individuals attempt to convert the profits from their participation in a project from income taxable at ordinary rates to long-term capital gain taxable only at a rate of 25 percent"; and "corporations lending themselves" to this "attempted tax-saving practice." See pp. 27-35, *supra*.

The legislative history of section 117(m) speaks for itself. The statute is directed solely against a specific tax abuse. It is narrowly concerned with corporations which are deliberately used to construct or produce property in order to obtain a special benefit or gain for stockholders through a liquidation or sale of stock. And that benefit or gain consists of having the usual profit earned on the property taxed as capital gain, where the same profit would otherwise be ordinary income if the corporation had realized it in the regular course of business or if the enterprise had been individually owned and operated. All the examples given in the hearings and committee reports involve precisely this kind of income, and no other. The examples on the building industry are conspicuously concerned

only with profits which are normally realized as ordinary income in the regular course of business. See pp. 30-31, 33-35, *supra.*

A corporation, then, is not collapsible merely because it was formed or availed of for the construction of property. Nor is it collapsible because there is a sale of stock or a liquidation before it realizes a substantial part of the net income to be derived from the property. A corporation is collapsible only if construction proceeded with a view to the shareholders' realization of gain attributable to the constructed property. And that proscribed gain is the profit which would be realized as normal business income, subject to ordinary tax, in the absence of the attempt "to take unfair advantage of the difference between the tax rates on ordinary income and the lower tax rates on capital gains." See p. 27, *supra.* "On this point the legislative history is decisive." The hearings and the committee reports are "an authoritative gloss." *Utah Junk Co.* v. *Porter*, 328 U.S. 39, 42 (1946). See also *Commissioner* v. *Bilder, supra,* at 503.

By the same token, Springfield and Hill were not collapsible corporations. For they were not used as a means of realizing the gain contemplated by the statute. The development was property used in a trade or business. If the corporations had directly sold the development, the profit would have been a capital gain. Int. Rev. Code of 1939, § 117(j). Again, if the petitioners had directly owned and sold the development, the profit would also have been a capital gain. *Ibid.* See pp. 3-6, and 21, *supra.* The Commissioner himself tacitly concedes, in light of the findings and uncontradicted evidence, that the petitioners "would have been entitled to capital-gains treatment had they con-

ducted the enterprise in their individual capacities without utilizing a corporation." Brief for Resp. on Pet. for Cert., p. 2.[7] The sale of the stock instead of the assets simply produced a similar capital gain.[8] At the same time, the corporations continued to realize the ordinary income from the property as ordinary income. In the very relevant words of this Court, the gain on the sale was "the realization of appreciation in value." It was not a conversion of profits "from the everyday operation of a business." See pp. 23-26, *supra*. Or, in the language of the President, there was no attempt whatever "to take unfair advantage of the difference between the tax rates on ordinary income and the lower tax rates on capital gains." See p. 27, *supra*. Since the gain was not a disguised realization of ordinary income from the constructed property, it was not "gain attributable to such property" within the meaning of section 117(m). Hence the Commissioner cannot tax the gain on the sale as ordinary income realized through a collapsible corporation. *United States* v. *Ivey*, *supra*.

To restate our conclusion, the statute was deliberately aimed at the conversion of ordinary income into capital gain. What the court below has done is

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[7] In this connection the Tax Court specifically found, as the Commissioner stipulated, that the petitioners' shares in Springfield and Hill were not stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of trade or business. (R. 19.)

[8] A portion of the gain was formally realized through distributions shortly preceding the sale. But as the court below held, the distributions were "part of the sale transaction" (R. 22), and it so treated them in its legal analysis. They were made pursuant to the terms of the sale and at the insistence of the buyers. See p. 5, *supra*.

to convert capital gain into ordinary income. It has very effectively turned section 117(m) into a penal levy. Taxpayers who have not engaged in any tax avoidance are punished for having held property through a corporation rather than as individuals.

II. The Court of Appeals Misconstrued the Words "Gain Attributable to Such Property"

The Court of Appeals recognized that if our view of the statute is correct, then Springfield and Hill were not collapsible corporations. But the court rejected our interpretation on the ground that section 117(m) "as literally written applies regardless of whether the assets constructed by the corporation would have produced capital gain or ordinary income if constructed and sold by the shareholder." (R. 35-36.) As this conclusion indicates, the court invoked the so-called "letter" of the statute. At the same time, however, the court conceded that its conclusion made little sense. See pp. 57, 68-69, *infra*.

The court's resort to "literalism" consists of two errors—quite apart from the absurdity of the result. First, the court gratuitously assumed that gain attributable to the constructed property, as contemplated by the statute, "literally" means only what the court thought it meant. Second, even if this "literal" assumption were correct, the court egregiously erred in ignoring the plain-spoken purpose and policy of section 117(m). Judge Learned Hand has wisely said, "There is no more likely way to misapprehend the meaning of language—be it in a constitution, a statute, a will or a contract—than to read the words literally, forgetting the object which the document as a whole is meant to secure." *Central Hanover B. & T. Co.* v.

Commissioner, 159 F. 2d 167, 169 (2d Cir. 1947). It would be hard to find a better case to illustrate this perceptive observation.

To seek aid and comfort from the "literal" meaning of the statute is merely to engage in obvious question-begging. For this mode of reasoning quietly assumes what it supposedly seeks to establish—that the phrase in question necessarily has only one intrinsic meaning, regardless of its particular context or purpose. This Court "long ago rejected" such mechanical notions of construction as "mischievous and misleading." *ICC* v. *J-T Transport Co.*, 368 U.S. 81,107 (1961) (dissent). See also *Association of Westinghouse Salaried Employees* v. *Westinghouse Elec. Corp.*, 348 U.S. 437, 444 (1955). "Anything that is written may present a problem of meaning, and that is the essence of the business of judges in construing legislation. The problem derives from the very nature of words. They are symbols of meaning. But unlike mathematical symbols, the phrasing of a document, especially a complicated enactment, seldom attains more than approximate precision. If individual words are inexact symbols, with shifting variables, their configuration can hardly achieve invariant meaning or assured definiteness." Frankfurter, *The Reading of Statutes*, in Of Law and Men 44, 45 (1956).

According to the court below, "gain attributable to such property" embraces any profit realized on a sale of stock, regardless of the nature of the profit or its relation to the ordinary income produced by the property. This view of the words the court then described as "literally" required. In short, the court maintained that the words inherently could not mean anything else. Mr. Justice Holmes neatly disposed of such

wooden construction—if construction it can be called—in an oft-quoted sentence. "A word is not a crystal, transparent and unchanged; it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used." *Towne* v. *Eisner*, 245 U.S. 418, 425 (1918). The meaning of words is shaped by the context in which they are used. The same word does not always express the same idea. "The word to be defined, in common with words generally, will have a color and content that will vary with the setting." *Hawks* v. *Hamill*, 288 U.S. 52, 57 (1933). See also *International Stevedoring Co.* v. *Haverty*, 272 U.S. 50, 52 (1926); *Boston Sand & Gravel Co.* v. *United States*, 278 U.S. 41, 46-47 (1928); *Jarecki* v. *Searle & Co., supra*, at 307. Hence the same word may have different meanings in different parts of the same statute. *Lamar* v. *United States*, 240 U.S. 60, 65 (1916).

In taxation, too, "most words admit of different shades of meaning, susceptible of being expanded or abridged to conform to the sense in which they are used." *Helvering* v. *Stockholms Enskilda Bank*, 293 U.S. 84, 87 (1934). And so the same word or phrase may have diverse meanings in diverse contexts. See, *e.g.*, *Burnet* v. *Chicago Portrait Co.*, 285 U.S. 1, 5 (1932); *United States* v. *Murdock*, 290 U.S. 389, 394 (1933); *United States* v. *Stewart*, 311 U.S. 60, 69 (1940); *Higgins* v. *Commissioner*, 312 U.S. 212, 217 (1941); *United States* v. *Pyne*, 313 U.S. 127, 131 (1941); *Helvering* v. *Reynolds*, 313 U.S. 428, 433 (1941). "The same meaning need not always be attributed to a phrase which, by hypothesis, has more than one meaning for purposes of statutory construction." *Helvering* v. *Morgan's, Inc.*, 293 U.S. 121, 128

(1934). Indeed, in tax law it is peculiarly fitting that the courts should carefully guide themselves by the purpose and context of the words involved. The meaning of a term "in a setting as complex as that of the revenue acts, however precise its language," cannot be properly ascertained "if the mind be isolated from the history of the income tax legislation of which it is an integral part." *Helvering* v. *Morgan's, Inc., supra*, at 126. See also *Spies* v. *United States*, 317 U.S. 492, 497 (1943); *Jarecki* v. *Searle & Co., supra*, at 307. Only recently the same words in successive tax statutes, dealing with the very same subject, were construed differently in view of "the Congressional purpose explicitly revealed in the House and Senate Committee Reports on the bill." *Commissioner* v. *Bilder, supra*, at 502. See also *Turnbow* v. *Commissioner*, 368 U.S. 337 (1961), where the Court made short shrift of the "literal" mode of construction. As the Court observed, on the basis of "plain words" both parties had made "plausible arguments" for "diametrically opposed conclusions." *Id.* at 339.

Legislative history is all the more significant where the application of a statute turns on such a protean concept as gain—whether it be the realization of a gain or the nature of a gain. See, *e.g.*, the majority and minority opinions in *Commissioner* v. *Crane*, 331 U.S. 1 (1947); and *Commissioner* v. *Wodehouse*, 337 U.S. 369 (1949). Compare *Bowers* v. *Kerbaugh-Empire Co.*, 271 U.S. 170 (1926), with *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359 (1931); and see *Dobson* v. *Commissioner*, 320 U.S. 489 (1943), *rehearing denied*, 321 U.S. 231 (1944). Compare further Mr. Justice Holmes' opinions in *Towne* v. *Eisner*, *supra*, at 426-427, and *Eisner* v. *Macomber*, 252 U.S. 189, 219-220

(1920). See generally Magill, Taxable Income (rev. ed. 1945). "Large concepts like 'property' and 'ownership' call for close analysis, especially when tax legislation is under scrutiny." *Whitney* v. *State Tax Commission*, 309 U.S. 530, 538 (1940). The concept of gain requires the same searching scrutiny. Like "property" and "ownership", it suggests a delusive exactness. Even a statutory term like "gross income" has a variable content, depending on its context in a particular case. Compare *United States* v. *Benedict*, *supra*, with *Helvering* v. *Bliss*, 293 U.S. 144 (1934); *Emma B. Maloy*, 45 B.T.A. 1104 (1941); *James M. McDonald*, 23 T.C. 1052 (1955); Rev. Rul. 56-191, C.B. 1956-1, 636. If there is no illuminating legislative history "which expressly settles the course to be followed," this Court will nevertheless "seek the purposes of the applicable sections of the Code and adopt that construction which best gives effect to those purposes." *United States* v. *Benedict*, *supra*, at 696. It refuses to take refuge in an evasive "literalism." In *Helvering* v. *Estate of Enright*, 312 U.S. 636, 643 (1941), this Court held that even the word "accrue," which is a staple term in accounting and taxation, is not "a word of art with a definite connotation when employed in describing items of gross income." And, as the Government successfully argued, the word was carefully read in accordance with Congress' purpose, though the meaning placed upon the word departed from its usual import. Cf. *Estate of Putnam* v. *Commissioner*, 324 U.S. 393, 397 (1945).

Words, then, are "inexact tools". Hence, no matter how "clear" a statute may seem on a hasty reading or superficial examination, nothing precludes the use of legislative materials in aid of its construction. See

Boston Sand & Gravel Co. v. *United States*, *supra*, at 46-48; *United States* v. *American Trucking Assns.*, 310 U.S. 534, 542-544 (1940); *Harrison* v. *Northern Trust Co.*, 317 U.S. 476, 479 (1943). "It would be anomalous to close our minds to persuasive evidence of intention on the ground that reasonable men could not differ as to the meaning of the words." *United States* v. *Dickerson*, 310 U.S. 554, 562 (1940). This Court has well said that questions of construction often emerge "where upon first reading the words seem clear. Generally, questions as to the meaning intended do not arise until the language used is compared with the facts or transactions in respect of which the intent and purpose are to be ascertained." *Helvering* v. *New York Trust Co.*, 292 U.S. 455, 465 (1934). In final analysis, despite all efforts to reduce construction to a mechanical process, the controlling principle is that "courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy." *S.E.C.* v. *Joiner Leasing Corp.*, 320 U.S. 344, 350-351 (1943). "The meaning to be ascribed to an Act of Congress can only be derived from a considered weighing of every relevant aid to construction." *United States* v. *Dickerson*, *supra*, at 562.

The same principle applies no less to tax statutes than other statutes. *Haggar Co.* v. *Helvering*, 308 U.S. 389, 394 (1940). The application of a revenue provision "is not an exercise in framing abstract definitions." *Bazley* v. *Commissioner*, 331 U.S. 737, 741 (1947). Tax statutes, like other statutes, "derive vitality from the obvious purposes at which they are

aimed." *Griffiths* v. *Commissioner*, 308 U.S. 355, 358 (1939). As Mr. Justice Sutherland wrote in a leading case on the construction of tax statutes, the "intention of the lawmaker controls in the construction of taxing acts as it does in the construction of other statutes." *Helvering* v. *Stockholms Enskilda Bank*, *supra*, at 93. See also *Commissioner* v. *Wodehouse*, *supra*, at 379.

The question here is not what the words in issue may mean as an abstract matter. The question is what they mean as concretely used in section 117(m). See *Jarecki* v. *Searle & Co.*, *supra*, at 307. And the phrase as used there "must draw its meaning from its function in that section." *Bazley* v. *Commissioner*, *supra*, at 740. When the right question is asked, the right answer readily follows. The meaning of the words involved here is unmistakably disclosed in the "authoritative pronouncements" made in the hearings and the committee reports. Cf. *Commissioner* v. *Bilder*, *supra*, at 503. Legislative words are obviously written with some purpose in mind. Therefore, they are appropriately construed in response to the problems they were designed to solve and the result they were designed to effect. The explanatory statements of those who conceive and draft a statute are the most significant indicia of what the statute means. See Landis, *A Note on "Statutory Interpretation,"* 43 Harv. L. Rev. 886, 888 (1930); Jones, *Statutory Doubts and Legislative Intention*, 40 Col. L. Rev. 957, 967 (1940).

To summarize our position at this point, there is no question here of doing violence to the "literal" language of the statute. For here we are considering a flexible phrase whose connotation depends on the context in which it appears. And the meaning of that phrase, as it is used here, "is to be ascertained, not

by taking the word or clause in question from its setting and viewing it apart, but by considering it in connection with the context, the general purposes of the statute in which it is found, the occasion and circumstances of its use, and other appropriate tests for the ascertainment of the legislative will." Once Congress' objective is "thus disclosed, it is enough that the word or clause is reasonably susceptible of a meaning consonant therewith, whatever might be its meaning in another and different connection." *Helvering v. Stockholms Enskilda Bank*, *supra*, at 93-94. In the *Stockholms Enskilda* case, unlike the present case, there were no committee reports or other authoritative statements which expressly spelled out the policy of Congress.[9] See also *Commissioner v. Wodehouse*, *supra*, at 377-380; *Jarecki v. Searle & Co.*, *supra*, at 307.

The Court has criticized the kind of interpretation which removes a few words from their setting, and

[9] In the *Stockholms-Enskilda* case the Government was far more sensitive to legislative policy than it has managed to be here. The question there was whether interest on a tax refund, paid by the United States to a foreign corporation, was taxable as "interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise," of the United States. The Government prevailed on the basis of the policy of the statute. The Court held that the United States was a "resident" of the United States for purposes of the statute. The opinion states, "While it cannot be said that the United States, in its corporate capacity as an artificial person, has a bodily presence in any place, it is not unreasonable to hold that in the eye of the law it has a residence, and especially so when a contrary holding would defeat the evident purpose of a statute." 293 U. S. at 91-94. Compare *United States v. Cooper*, 312 U. S. 600 (1941), with *Georgia v. Evans*, 316 U. S. 159 (1942), involving a similar interpretative issue over the word "person." And see *Parker v. Brown*, 317 U. S. 341, 351 (1943), which attributes the diverse interpretations of the same word to "the purpose, the subject matter, the context and the legislative history" of the particular statute.

then proceeds to construe them as so isolated. See *United States* v. *American Trucking Assns., supra,* at 542. At times this sort of construction produces a conclusion that it "would appear senseless for Congress to adopt." *Jarecki* v. *Searle & Co., supra,* at 308. This is precisely what has happened here. And so the court below arrived at the strange conclusion that a statute designed to prevent the conversion of ordinary income into capital gain has just the opposite effect of converting capital gain into ordinary income.

We have argued that this case does not present any problem of "literal" meaning. The phrase "gain attributable to such property" derives its content from its context. However, the correct answer is the same even if we erroneously assume that the phrase "literally" means what the Court of Appeals imputed to it. Under that "literal" view, we have seen, the gain attributable to the property includes any profit realized on the sale of stock, regardless of the economic content of the profit. It makes no difference whether the profit constitutes a conversion of normal business income or a realization of a true capital gain. And, as we further understand this "literal" rendition, there is no choice but to submit to it in helpless fashion, though it fails to make sense.

Fortunately, this Court has refused to acquiesce in such sterile notions of statutory construction. It has definitively disapproved "a literal interpretation dogma which withholds from the courts available information for reaching a correct conclusion." *United States* v. *American Trucking Assns., supra,* at 544. See also *Association of Westinghouse Salaried Employees* v. *Westinghouse Elec. Corp., supra,* at 444. To construe a statute is to ascertain its meaning, and that

meaning is to be determined in the light of its history and purpose. "The decisions of this Court have repeatedly warned against the dangers of an approach to statutory construction which confines itself to the bare words of a statute," for "literalness may strangle meaning." *Lynch* v. *Overholser*, 369 U.S. 705, 710 (1962); *Utah Junk Co.* v. *Porter, supra*, at 44. In the words of Mr. Justice Frankfurter, "The notion that because the words of a statute are plain, its meaning is also plain, is merely pernicious oversimplification. It is a wooden English doctrine of rather recent vintage . . . to which lip service has on occasion been given here, but which since the days of Marshall this Court has rejected, especially in practice." *United States* v. *Monia*, 317 U.S. 424, 431 (1943) (dissent).

Therefore, no matter how "plain" the words may be, the Court will not read them so as to produce absurd, harsh, or incongruous results. Even when the bare words do not entail an absurd result, but an unreasonable one, "plainly at variance with the policy of the legislation as a whole," the Court refuses to indulge in blind literalness or to sacrifice common sense. See, *e.g.*, *United States* v. *American Trucking Assns., supra*, at 543; *Church of the Holy Trinity* v. *United States*, 143 U.S. 457, 459 (1892); *Haggar Co.* v. *Helvering, supra*, at 394-95; *Textile Mills Securities Corp.* v. *Commissioner*, 314 U.S. 326, 333-334 (1941); *Markham* v. *Cabell*, 326 U.S. 404, 409 (1945). As the Court stated in *Ozawa* v. *United States*, 260 U.S. 178, 194 (1922), "we must examine the matter further. We may then look to the reason of the enactment, and inquire into its antecedent history, and give it effect in accordance with its design and purpose, sacrificing, if necessary, the literal meaning in order that the purpose

may not fail." The short of the matter is that "all laws are to be given a sensible construction". An outlandish or incongruous reading should be sedulously avoided whenever the statute can be reasonably applied, "consistent with the legislative purpose." *United States* v. *Katz*, 271 U.S. 354, 357 (1926); *United States* v. *Kirby*, 7 Wall. 482, 486 (1869).

In so far as we are aware, this principle fully applies to tax statutes. See *Haggar Co.* v. *Helvering*, *supra*, at 394. Even revenue laws should be read so as to make sense—especially when Congress and the Treasury have clearly and cogently indicated the sense to be made. The construction of statutes is not a game in which the purpose is to display verbal ingenuity for the sake of the highest possible tax, in bland disregard of Congress. It is a painstaking effort to apply the words of Congress as Congress meant them to be applied.

We are only saying what the Government itself repeatedly urges before the Court—and successfully so. For example, in a series of cases on corporate reorganizations the Court "has withheld the benefits of the reorganization provision in situations which might have satisfied provisions of the section treated as inert language, because they were not reorganizations of the kind" with which the statute "in its purpose and particulars concerns itself." *Bazley* v. *Commissioner*, *supra*, at 741. As Mr. Justice Douglas put it, "a transaction may not qualify as a 'reorganization' under the various revenue acts though the literal language of the statute is satisfied." *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 182 (1942). See further *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462 (1933); *LeTulle* v. *Scofield*, 308 U.S. 415

(1940). Even in an area so diverse and complex as corporate reorganizations, "the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create." A reorganization is not necessarily a tax-free transaction, "though the facts answer the dictionary definitions of each term used in the statutory definition." The meaning of each term is to be derived from the purpose of the statute and its "underlying presupposition." *Helvering* v. *Gregory*, 69 F. 2d 809, 810-811 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

Even more important here, the Court has similarly construed the basic provisions on capital gains. Various gains have been denied capital gain treatment in accordance with legislative history and policy, though the statutory language, abstractly considered, is easily broad enough to encompass such gains. See pp. 23-26, *supra*. In *Corn Products Co.* v. *Commissioner*, *supra*, the Court readily agreed that "the literal language" of section 117(a) did not exclude the property in question from the definition of "capital assets". But it nevertheless held that the statute "must not be so broadly applied as to defeat rather than further the purpose of Congress." Therefore, the special treatment for capital gains did not apply to gains representing profits "arising from the everyday operation of a business," as distinguished from transactions "which are not the normal source of business income." 350 U.S. at 51-52. As the Court later stated, "not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset." *Commissioner* v. *Gillette Motor Transport*, *supra*, at 134.

What is true of section 117(a) is necessarily just as true of section 117(m). For subsection (m) is merely a policing provision that was designed to safeguard the policy expressed in subsection (a). The purpose of subsection (a) is to draw a line between profits from the everyday operation of a business and profits from appreciation accrued over a period of time. The purpose of subsection (m) is to hold that same line against schemes which would make inroads upon it through the adroit use of a corporation. If subsection (a) makes no attempt to tax profits from appreciation as ordinary income, how, then, can any purpose to do so be reasonably attributed to subsection (m)? Since the aim of subsection (m) is to sustain the purpose of subsection (a), we labor the obvious when we say that both are animated by the same purpose. And to disregard that purpose is to assume that subsection (m) must be "so broadly applied as to defeat rather than further the purpose of Congress." Such assumptions should not be gratuitously attributed to Congress.

As Judge Learned Hand wrote, after many years of thoughtful concern with legislation, "statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning." *Cabell* v. *Markham*, 148 F. 2d 737, 739 (2d Cir. 1945), *aff'd*, 326 U.S. 404 (1945). This cardinal principle of interpretation is commonly applied in behalf of the Government. See pp. 50-51, *supra*. See also *Helvering* v. *Clifford*, 309 U.S. 331 (1940); *Commissioner* v. *Wodehouse*, *supra*; *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 81-86 (1960); *Jarecki* v. *Searle & Co.*, *supra*, at 309-313. The same principle no less prevails when an unduly "literal" reading would inflict a "harsh and incon-

gruous result" on the taxpayer. *Haggar Co.* v. *Helvering, supra,* at 395. See also *Helvering* v. *New York Trust Co., supra,* at 464-465. It is not a one-way street generously provided for the sole convenience of the Government. In one case, as in the other, the taxing statute "must be construed with reference to" its "presuppositions and purpose." *Bazley* v. *Commissioner, supra,* at 740. While at times the purpose of Congress is obscure, no such excuse can be pleaded here.

Again we are only saying what the Government itself has said on another occasion. In Rev. Rul. 56-50, C.B. 1956-1, 174, the Commissioner carefully probed the question whether the definition of a collapsible corporation should be construed in "literal" fashion or in accordance with its intended purpose. Two individuals owned the stock of a corporation which, in turn, owned the stock of five subsidiaries. Each subsidiary built and operated a housing development. The parent sold its stock in all five subsidiaries. The two individuals next proposed to liquidate the parent. The question before the Treasury was whether the gain realized by the stockholders on the liquidation would be taxable as ordinary income on the ground that the parent was a collapsible corporation. It was assumed, for the purpose of resolving this issue, that the five subsidiaries were collapsible corporations, and therefore the gain realized by the parent on the sale of their stock was ordinary income.

The definition of a collapsible corporation includes a holding company as well as an operating company. The relevant words are "a corporation formed or availed of principally for the . . . construction . . . of property, or *for the holding of stock in a corporation so formed or availed of,* with a view to . . . the sale or

exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation . . . constructing . . . the property of a substantial part of the net income to be derived from the property." (Italics supplied.) This definition, the Commissioner observed, refers only to the realization of income by the corporation producing the property, as distinguished from the holding company. "If, prior to such realization, the parent and subsidiary corporations are both liquidated or the stock of the parent corporation is sold," the provision is "automatically applicable to the parent corporation." *Id.* at 175. "A literal reading of the statute," the Commissioner then stated, "would seem to produce the same result even though the parent corporation had first realized ordinary income by virtue of its sale of the entire stock of the subsidiary. Since the statute refers only to the realization of taxable income by the corporation producing the property, and not to any realization by the corporation holding its stock, it would appear under the literal language of the statute that the corporation holding stock of a collapsible corporation would still be a collapsible corporation even though it had been taxed as the shareholder of a collapsible corporation." *Ibid.*

However, the Commissioner refused to yield helplessly to a "literal reading" of the statute. To apply the statute twice to the same property, he reasoned, "would extend the statute beyond its intended purpose." The legislative history of section 117(m) "makes it clear that the objective was to prevent the successful use of a device for converting ordinary income into long-term capital gain through the medium of a corporation." *Id.* at 175-176. After referring to

the committee reports, the Commissioner continued as follows: "Where ordinary income is realized at the corporate level by the sale of the stock of a collapsible subsidiary, the evil at which the statute was aimed is not present and the effect of the literal interpretation suggested earlier would be to impose what would amount to a penalty tax at the shareholder level through requiring the gain attributable to property produced by a collapsible subsidiary to be taxed at both levels as ordinary income. There is no evidence in the legislative history that Congress intended such a result. Thus, it would be unreasonable to adopt the suggested literal interpretation." *Id.* at 176.[10]

While Rev. Rul. 56-50 dealt with a different part of the statute defining a collapsible corporation, the ruling is nevertheless highly significant here. First, the Commissioner ruled that the statute should be meticulously construed in response to "the evil at which the statute was aimed," even if it "literally" reads otherwise. The section should not be extended "beyond its intended purpose." Second, the Commissioner very precisely summarized the "intended purpose" which determines the appropriate application of section 117(m). In his own words again, the legislative history "makes it clear that the objective was to prevent the successful use of a device for converting ordinary income into long-term capital gain through the medium of a corporation." And in the light of that "clear" purpose, the Commissioner rightly refused to apply

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[10] In support of his decision to apply the statute in accordance with its purpose, the Commissioner cited this Court's opinions in *Church of the Holy Trinity* v. *United States*, *supra*; *Helvering* v. *New York Trust Co.*, *supra*; *Haggar Co.* v. *Helvering*, *supra*; and *United States* v. *American Trucking Assns.*, *supra*.

the section in the case before him. Otherwise he would have imposed an "unreasonable" result "beyond its intended purpose."

Here it should be much easier for the Commissioner to exercise his aversion to "literalness" than in the case just summarized. There the Commissioner was obliged to supply, through the process of construction, an omission which the draftsmen had overlooked. In order to reach a proper conclusion, he had to infer the presence of missing words. Cf. *St. Louis-San Francisco Ry.* v. *Middlekamp*, 256 U.S. 226, 232 (1921). Here, in distinct contrast, there is no problem of supplying an omission. The question is simply one of properly construing a phrase which is explicitly in the statute.[11]

Once "the tyranny of literalness is rejected" (*United States* v. *Witkovich*, 353 U.S. 194, 199 (1957)), the proper result here is also immediately apparent. Springfield and Hill were not collapsible corporations because they were not—in the Commissioner's words—"a device for converting ordinary income into long-term capital gain through the medium of a corporation." If the petitioners had owned the development as individuals, the gain realized on the sale would have been a long-term capital gain. See pp. 38-39, *supra*. On the other hand, if section 117(m) is applied

[11] For another example where the Commissioner refused to be "literal", see Rev. Rul. 56-104, C.B. 1956-1, 178. Under section 117(m) the definition of a collapsible corporation turns, in part, on the corporation's failure to realize net or taxable income before the sale of the stock. See p. 20, *supra*. In Rev. Rul. 56-104 the Commissioner held that a foreign corporation was not a collapsible corporation, although "for Federal income tax purposes" it could not realize any net or taxable income.

here on the pretext of "literalness," the result will be harsh and incongruous, as well as plainly absurd. It will squarely contradict the result so clearly contemplated by Congress. Instead of preventing the conversion of ordinary income into capital gain, the Commissioner will harshly penalize the petitioners by converting capital gain into ordinary income. They will be severely punished merely because they owned the property through corporations rather than as individuals. In fact, the court below expressly conceded that its "literal" understanding of the statute "produces unwarranted taxation of capital gains as ordinary income." (R. 36.) To use the Commissioner's apt words again, "the evil at which the statute was aimed is not present." The deficiencies asserted by him would inflict "what would amount to a penalty tax." See p. 55, *supra*. Certainly, the result sought by the Commissioner hardly reflects that "sympathetic and imaginative" spirit in which statutes should be read and applied.

Our conclusion is amply fortified by *United States* v. *Ivey*, *supra*, which construed section 341 of the 1954 Code—the successor to section 117(m). In the *Ivey* case the Fifth Circuit held the that the statute does not apply to "taxpayers who would have been entitled to capital gains treatment, without having incorporated." It "does not penalize the taxpayer by converting his capital gain into ordinary income." Moreover, the Court declared, the Commissioner's construction "would make nonsense of the statute." The legislative history "shows beyond dispute that the mischief" at which it aimed "was the taxpayers' abuse of the corporate device as a technique for transmuting ordinary income into capital gains. Only by reading this

purpose into the words of the law can it be said that the law has a plain meaning." "The corrective statute was designed to collapse the corporate facade and impose the ordinary income treatment which the transactions deserve." "Carefully defined principles have been evolved for determining the circumstances under which income should receive capital gains treatment. The determination rests primarily on the character of the gain and the relation of the nature of the gain to the nature of the taxpayer's business. The collapsible corporation provisions conform with these prinsiples. It would be ironic if the provisions were construed to require earnings which ordinarily should be capital gains to be treated as ordinary income." 294 F. 2d 799, 802-804 (5th Cir. 1961).

"There is no way," the Fifth Circuit emphasized, "to fit in such a result with a rational pattern of capital gains taxation. If, for tax purposes, the corporate form is ineffective and the court should pierce the corporate veil, the gains should be attributed directly to the shareholder. In such a case they should be capital gains, if the individual is entitled to capital gains treatment. If, on the other hand, the court should not pierce the corporate veil, the sale of the shareholder's stock should be treated as if it were the sale of any other capital asset. To construe this statute to make the taxpayer's profits taxable as ordinary income, even though in the absence of a corporation they would have been capital gains, would be to carve out a special group of cases for special treatment inconsistent with that accorded capital gains generally." The opinion concludes that the statute "should not be read as applicable to cases where the shareholder's gain would be taxable as a capital gain had he realized it directly

rather than through the corporate vehicle." Any attempt to apply it in that situation would necessarily impose an irrational hardship. *Id.* at 804-805.

Of course, we are not suggesting that there is any discrepancy here between the "letter" of the statute and the plain-spoken purpose of Congress. As we have argued, the phrase "gain attributable to such property" is not a term of art with some fixed meaning acquired over many years. It is a flexible term that derives its content from its context. *Cf. International Stevedoring Co. v. Haverty, supra*, at 52. And here it "came freighted with the meaning imparted to" it "by the mischief to be remedied and by contemporaneous discussion." *Duparquet v. Evans*, 297 U.S. 216, 221 (1936). The phrase is part of a special statute drawn for a specific purpose. "A few words of general connotation appearing in the text of statutes should not be given a wide meaning contrary to a settled policy, 'excepting as a different purpose is plainly shown.'" *United States v. American Trucking Assns., supra*, at 544. As the Court recently emphasized in a tax case, a word of variable meanings should be interpreted so as "to avoid the giving of unintended breadth to the Acts of Congress." *Jarecki v. Searle & Co., supra*, at 307. The controlling purpose here is clearly spread and elaborated on the legislative record, and that purpose is embedded in the settled policy which this Court has carefully fulfilled over the years. See pp. 23-26, *supra*. To sever the statute from that purpose is to mutilate the statute.

In any event, regardless of how "plain" the phrase may otherwise seem, it should be closely construed in accordance with Congress' purpose, and the Treasury's purpose as contemporaneously expressed to Congress.

Courts are particularly sensitive to any effort to impute "absurd results" to "words of general meaning." This is "a case where there was presented a definite evil, in view of which the legislature used general terms with the purpose of reaching all phases of the evil." *Church of the Holy Trinity* v. *United States, supra,* at 472. Given the clear purpose of the section, our conclusion is the only natural and appropriate one. The words of the statute should not be bent so as to distort that purpose. Neither the hearings nor the reports reveal the slightest desire to tax, as ordinary income, profits which are otherwise normally realized as capital gains. "Nowhere in the reports of the Committees does it appear that any such novel legislation was being proposed as is here contended for by the government." *United States* v. *Katz, supra,* at 360. If we may somewhat revise a well-known dictum of Mr. Justice Holmes, the words used by Congress should not be assiduously pursued to a drily illogical extreme.

III. The Petitioners' Position Is Confirmed By Other Provisions of the Statute

Our conclusion is not only sustained by the purpose of Congress, so clearly articulated in the hearings and committee reports. It is also several times confirmed by the scheme and structure of section 117(m). We are not concerned here with a single phrase or term in an isolated sentence, but with a group of words which are entwined with other segments of an elaborate statute. *Cf. Flora* v. *United States*, 362 U.S. 145, 157 (1960). "There is need to keep in view also the structure of the statute, and the relation, physical and logical, between its several parts." *Duparquet* v. *Evans, supra,* at 218. See also *Richards* v. *United States, supra,* at 11. This is particularly true of tax legislation,

"however precise its language." *Helvering* v. *Morgan's, Inc., supra*, at 126. The phrase to be construed here "does not stand alone, but gathers meaning from the words around it." *Jarecki* v. *Searle & Co., supra*, at 307.

A collapsible corporation is "a corporation formed or availed of principally for the . . . construction . . . of property . . . with a view to" the shareholders' realization of "gain attributable to such property." The "view" and "gain," then, are interrelated elements of one over-all rule of law created by the statute. The meaning of the statute is accordingly illuminated by their mutual relationship.

Clearly, section 117(m) is one of many statutes "in which purpose or state of mind determines the incidence of an income tax." *Helvering* v. *National Grocery Co.*, 304 U.S. 282, 289 (1938). *Cf. Commissioner* v. *Culbertson*, 337 U.S. 733, 743 (1949). The words "with a view to" predicate liability on "a state of mind which must attend and gives significance to certain action." *Jacobson* v. *Commissioner*, 281 F. 2d 703, 705 (3d Cir. 1960). That state of mind is the purpose to obtain the proscribed gain.

The phrase "with a view to" is colloquial English with a familiar meaning. According to common understanding, it means "with the purpose or aim of" or "calculating upon or contemplating as a desired result." Webster, New International Dictionary (2d ed. unabridged, 1948); Fowler, A Dictionary of Modern English Usage 693 (1947); Nicholson, A Dictionary of American-English Usage 629 (1957). See also *Mortensen* v. *United States*, 322 U.S. 369, 373-374 (1944), where the Court used "with a view toward" as synonymous with "for the purpose of," "with the

intent and purpose," and "intention and motivation." Nothing in the legislative history of section 117(m) suggests or implies that the phrase expresses any concept other than this ordinary and everyday meaning. On the contrary, according to the legislative history the phrase was used as it is usually understood in intelligent discourse. Again and again the collapsible corporation is described as "a device"—something which is purposefully used or contrived for a desired end. See pp. 27-35, *supra*. "The existence of the defined purpose is a condition precedent to the imposition of the tax liability" imposed by the statute. *Helvering* v. *National Grocery Co., supra,* at 289.

We need hardly add that "with a view to" necessarily limits the statute to construction specifically prompted by the desire to obtain the gain attributable to the construction. A corporation is collapsible only if used for construction as a calculated means of realizing that benefit. As the Treasury repeatedly emphasized before the Ways and Means Committee, section 117(m) is solely concerned with abnormal behavior inspired by that advantage. See pp. 27-34, *supra*. Like section 102,[12] it is directed against the studied departure from normal corporate enterprise "to avoid taxes." *United Business Corporation* v. *Commissioner,* 62 F. 2d 754, 756 (2d Cir. 1933), *cert. denied,* 290 U.S. 635 (1933). See also *id.,* 19 B.T.A. 809, 828 (1930).

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[12] Section 102 of the 1939 Code is a special tax on corporations "formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed." See *Helvering* v. *National Grocery Co., supra; Helvering* v. *Chicago Stock Yards Co.,* 318 U.S. 693 (1943). Section 102 has been succeeded by sections 531 and 532 of the 1954 Code.

All the emphasis on purpose or motive, within and without the statute, plays a vital role in its meaning and application. It is designed to make sure that the statute is closely confined to corporations that are intentionally used to secure the proscribed gain through a sale or exchange of stock. Therefore, that gain must be some special advantage not obtainable in normal fashion by the corporation itself or by the shareholders as direct owners of the enterprise. And that advantage or gain can only be profit that constitutes an attempted conversion of ordinary income into capital gain. Otherwise the pronounced emphasis on purpose or motive makes little sense. For the statute is then read as saying that a corporation is collapsible if it is calculatedly used as a means of realizing a capital gain which is otherwise normally realized as a capital gain. We are at a complete loss to understand why Congress would pass a statute which is so devoid of rhyme or reason. Nor did the court below make any effort to supply any explanation.

Another part of the statute—clause (i) of section 117(m)(2)(A)—is equally revealing. Under that clause a corporation, if it is to be deemed collapsible, must be formed or used for construction with a view to "the sale or exchange of stock by its shareholders" before the corporation itself realizes "a substantial part of the net income to be derived from the property." See p. 20, *supra*. As the committee reports indicate, this "net income" is the normal profit to be derived from the property in the ordinary course of the business. The special provision on this "net income" from the property significantly reinforces our construction of "gain attributable to such property."

The committee reports describe a collapsible corporation as "a device whereby one or more individuals attempt to convert the profits from their participation in a project from income taxable at ordinary rates to long-term capital gain taxable only at the rate of 25 percent." *They point out that in the* absence of this "device", a "legitimate corporation" engaged in business "would pay ordinarily the corporate income tax on its net income." Where the "device" is used, "the corporation pays no tax, claiming that it has realized no income." After summarizing the statute, the reports state that a collapsible corporation "is so defined as to include corporations lending themselves to the attempted tax-saving practice outlined above," namely, the attempted conversion of "income taxable at ordinary rates to long-term capital gain" taxable only at 25 percent. Then the reports add: "The corporation, furthermore, has been so defined as to describe corporations different in kind from those which ordinarily liquidate following normal business operations. This objective has been specifically strengthened by the statement made in subparagraph (i) above, to the effect that the sale or exchange or the distribution be made prior to the realization by the corporation of a substantial part of the net income to be derived from the property." H. R. Rep. No. 2319, *supra*, at 56-57, 96-97; Sen. Rep. No. 2375, *supra*, at 45, 88-89.

According to the reports, then, the "net income" so advisedly included in the definition is "the profits" from "participation in a project" which are "taxable at ordinary rates." Again in the language of the reports, they are the profits which are the subject of "the attempted tax-saving practice" of converting ordinary income into capital gain. The collapsible cor-

poration has therefore been defined so as to exclude corporations which have realized a substantial part of such income before the sale or exchange of stock. At that point they have engaged in "normal business operations," subject to the ordinary rates. They have paid "the corporate income tax" that a "legitimate" corporation "would pay ordinarily." *Hence they should not be proscribed* as "corporations lending themselves to the attempted tax-saving practice" condemned by the committees. See also pp. 34-35, *supra*.

In brief, section 117(m) is applied in relation to the amount of "net income" earned and to be earned from the property. And that "net income" is the ordinary business profit realizable by the corporation in its "normal business operations." Compare *Helvering* v. *Elbe Oil Land Development Co.*, 303 U.S. 372, 375-376 (1938); *Darley-Lynde Co.* v. *Alexander*, 51 F. 2d 56, 58-59 (10th Cir. 1931), *cert. denied*, 284 U.S. 666 (1931); G.C.M. 1023, C.B. VI-1, 19, 20 (1927); and see *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 316 (1956); *Commissioner* v. *Lake*, *supra*, at 264. The statute is in terms of such "net income" in order to compel the corporate realization of substantial profit taxable at ordinary rates. But all this concern with ordinary income at the corporate level is pointless unless the gain proscribed at the stockholder level constitutes such ordinary income converted into capital gain. The construction of the court below rests on the implicit premise that a provision so carefully included serves no purpose.

Still another portion of the statute sheds further light on the nature of the Commissioner's mode of construction. Paragraph (1) of section 117(m) provides that gain realized on a sale of stock in a collap-

sible corporation is taxable as ordinary income. Obviously, the gain is treated as ordinary income in order to compensate for the fact that the same gain would normally be realized and taxed as ordinary income. As the General Counsel of the Treasury explained to the Ways and Means Committee, the statute looks through "the corporation device as a mere sham, organized not for the purpose of carrying on business, but only for the particular purpose of carrying out what we would characterize as tax avoidance." See p. 33, *supra*. Cf. *Moline Properties* v. *Commissioner*, 319 U.S. 436, 439 (1943). The statute accordingly taxes the profit realized by the stockholder as the ordinary income it would have been in the absence of incorporation. Therefore, once more it necessarily follows—if the statute is to be sensibly read—that the gain attributable to the property is gain which constitutes a conversion of ordinary business profit. Why would Congress otherwise tax the gain as ordinary income? See p. 52, *supra*.

All these additional considerations converge to the same conclusion that Springfield and Hill were not collapsible corporations. To put it mildly, the Commissioner would impose "an unreasonable result plainly at variance with the policy of the legislation as a whole." *Ozawa* v. *United States*, *supra*, at 194. To put it more accurately, he would impose a result that is both harsh and absurd. See pp. 56-59, *supra*.

In the felicitous phrasing of Judge Learned Hand, "interpretation is the art of proliferating a purpose which is meant to cover many occasions so that it shall be best realized upon the occasion in question." *Brooklyn Nat. Corp.* v. *Commissioner*, 157 F. 2d 450, 451 (2d Cir. 1946), *cert. denied*, 329 U.S. 733 (1946). See also *Universal Camera Corp.* v. *Labor Board*, 340 U.S.

474, 489 (1951); *United States* v. *Shirey*, 359 U.S. 255, 261 (1959). Here the purpose of Congress is "best realized"—indeed, only realized—by our reading of the statute. The Commissioner's construction would completely disregard that purpose—even at the cost of reducing the statute to an absurdity. Our view has other virtues, too. It "safeguards the interests of the Government" as they were meant to be protected, and it "avoids gratuitous resentment in the relations between Treasury and taxpayer." *Rosenman* v. *United States*, 323 U.S. 658, 663 (1945). For over 40 years gain from the sale of stock has been taxed as a capital gain, not ordinary income. Section 117(m) creates an exception to that principle aimed at a particular abuse of that principle. The statute should not be loosely extended well beyond the target at which Congress very deliberately aimed.

"The problem" in the end "is to stick with the legislative scheme and determine which construction is most consonant with it." Douglas, *Legal Institutions in America*, in Legal Institutions Today and Tomorrow 274, 289 (1959). We submit that our construction of section 117(m) is easily "most consonant with" the scheme of section 117(m). "No calm, fair-minded person can violently disagree with the underlying purpose of legislative and other attempts to prevent the avoidance of tax." By the same token, however, such measures should not be indiscriminately applied as if Congress were engaged in a Herod's massacre. Paul, Studies in Federal Taxation 64-66 (1937). A statute directed against avoidance should be carefully confined to those that it was designed to reach. There has been no avoidance here. The Commissioner has not been deprived of what he was

otherwise entitled to receive. His attempted application of the statute is nothing less than a perversion of its purpose. And it is a perversion that cannot even plead a rational excuse. Statutes are not given a meaning which it "would appear senseless for Congress to adopt." *Jarecki* v. *Searle & Co., supra*, at 308.[13]

IV. The Court of Appeals Misconstrued the Legislative History and Purpose of the Statute

We have analyzed the "literal" construction on which the decision below rests. Evidently, even the Court of Appeals found it less than adequate. Nor is it difficult to understand why the court was not entirely satisfied. To begin with, the court tacitly conceded that if the petitioners had owned the development individually, the gain on the sale would have been capital gain. Next, it frankly confessed that the application of the section in this situation "produces

[13] The Court of Appeals attempts to bolster its "literal" rendition by stating: "The commentators have generally assumed that the collapsible corporation section would be literally interpreted by the courts." (R. 36.) The question here is what the statute meant to Congress, not what others may have feared the courts would do. Needless to add, articles by pessimistic commentators do not justify a tax which the Commissioner cannot otherwise sustain. Furthermore, the Court of Appeals' summary of the commentators' views is quite incomplete. For example, one of the cited authors severely criticized the early decisions of the Tax Court for disregarding the legislative history and policy of section 117(m). As he particularly stated, "presumably the fact that the taxpayer would have enjoyed capital gain on the sale of the corporate property if it had been held and sold by him directly will be no ground for avoiding the application of the Section in the Tax Court. Indeed, in many cases the legislative purpose will be perverted and capital gain will be converted into ordinary income." Anthoine, *Collapsible Corporations; 1957 Developments*, 16 N.Y.U. Inst. on Fed. Taxation 658, 661 (1958).

unwarranted taxation of capital gains as ordinary income." (R. 36.) In a further effort to sustain the deficiencies, the court turned to other grounds for its conclusion. These other grounds are supposed to prove that while the result is "unwarranted," it is nevertheless impeccably correct. However, as we shall now indicate, the opinion scarcely improves as it goes along.

The court first observes that our position rests on a misconception of the statute. "The taxpayers in this case and the Fifth Circuit in *Ivey*," the court states, "assume that the sole purpose of the collapsible corporation provision was to deal with those cases where the shareholder would have had ordinary income if he had sold the assets himself. However, the legislative history discloses that Section 117(m) had another major purpose." (R. 36.) The court then discusses two kinds of property not held for sale to customers in the ordinary course of trade or business. The two kinds are a motion picture and an apartment building produced and held for rental. "If an individual made a movie or constructed an apartment building, income received from the rental of the movie or building would be ordinary income. Thus, some taxpayers formed a corporation to make the movie or construct the apartment building and then liquidated the corporation after the movie or the building was finished. On liquidation the shareholders were taxed at capital gain rates on the difference between their basis in the stock and the fair market value of the movie or apartment building, but the shareholders' basis in the movie or apartment building was stepped up to fair market value. The shareholders could then rent out the movie or apartment building and amortize or depreciate their stepped-up basis against rental income. Congress en-

acted Section 117(m) to make the shareholders' gain on liquidation ordinary income rather than capital gain. If an individual had made a movie with the intention of renting it, he would have capital gain on a subsequent sale since it would not have been held primarily for sale to customers in the ordinary course of his trade or business." (R. 36-37.) This reasoning leads on to the following conclusion: "Therefore, the collapsible corporation provision was intended to apply to some cases when the asset if sold by the taxpayer would have produced capital gain. However, if the *Ivey* decision is applied where a movie is made by a corporation which is then dissolved, the collapsible corporation provision will have no application to the basic fact situations which prompted its enactment." (R. 37.)

Having reasoned its way to a conclusion that it finds disturbing, the Court of Appeals then proceeds to build upon it. "Of course, this difficulty," it states, "could be remedied by interpreting the *Ivey* decision as applicable only to sales of stock and not to liquidations. Thus, when the stock of a corporation is sold, it would not be collapsible if the underlying assets would have produced capital gain had no corporation been used, but when a corporation is liquidated, it would be collapsible regardless of whether the underlying assets would have produced capital gain had no corporation been formed. However, since Congress chose to use a single statute to deal with both types of cases, it seems unwise for the courts to create the additional complexities inherent in such a two-fold interpretation." The court then vaguely intimates that the alleged "complexities" would be too difficult for the courts to handle. (R. 37.)[14]

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[14] At this point the opinion refers to an amendment enacted in 1958. This amendment is discussed at pp. 81-94, *infra*.

We respectfully submit that this entire reasoning derives from a plain misunderstanding of the statute, as well as our own position. The difficulties which trouble the court are entirely of its own making.

We are not remotely contending that "the sole purpose of the collapsible corporation provision was to deal with those cases where the shareholder would have had ordinary income if he had sold the assets himself." Nor are we unaware that section 117(m) was meant to encompass liquidations of corporations as well as sales of stock. Our summary of the extensive legislative history fully discloses that fact with the required detail. The basic vice of the court's reasoning is a loose assumption in which it engages on its own. The court erroneously supposes that the enactment of section 117(m) had two separate purposes. The first alleged purpose was to deal with sales of stock. The second alleged purpose was to deal with liquidations of corporations. On the basis of this premise the court then makes a broad leap to its conclusion. That conclusion, briefly stated, is this: if the statute applies to a profit realized in the case of a liquidation, then it necessarily applies to a profit realized in the case of a sale of stock. In other words, it is wholly immaterial that the profits from the sale and from the liquidation are distinctly unlike. And, as we further understand the court's opinion, it makes no difference that the resulting tax in the case of the sale is "unwarranted," for this is the conclusion that Congress allegedly ordained.

In our view Congress is entitled to much more respect for its efforts to devise a fair tax system. The enactment of section 117(m) was designed to serve one over-all purpose—to prevent the conversion of "ordinary business income into the more favorably treated

capital gains." See p. 29, *supra*. Such conversions were effected in different ways, depending on the property involved. For example, in the motion picture industry, where films are rented, the procedure was to liquidate the corporation, report a capital gain based on the fair market value of the film, rent the film as the corporation would have done, and amortize the value of the film against the receipts from the film. See pp. 29, 34, *supra*. The stockholders were able to have their cake, and eat it, too. They continued to own the film, and their rental income was taxed as capital gain. On the other hand, in the building business the situation was different. As the hearings and committee reports indicate, the Treasury and Congress were concerned with contractors who "construct buildings for sale." See pp. 30-31, 33-35, *supra*. If a contractor built and sold properties as an individual, the profits were ordinary income. If he did so through a corporation, the profits were also ordinary income. The artful use of a corporation enabled contractors to convert these profits into capital gain in either of two ways. One procedure was to liquidate the corporation, report a capital gain based on the fair market value of the houses, sell the houses as the corporation could have done, and apply that value against the sales price. In this way normal business income was transmuted into capital gain to the extent of the reported value of the houses. The other procedure, producing the same conversion, was to sell the stock in the corporation at a price equal to the same value.

In some cases, then, the ordinary income so converted was rent from property which the stockholders continued to own and lease. In other cases the ordinary income so converted was profit from the sale of prop-

erty to customers in the regular course of business. In order to reach every kind of converted ordinary income, the draftsmen had to cover both liquidations of corporations and sales of stock—which is precisely what they did. The one and only purpose was to prevent conversions in each and every case, regardless of which method was used. But it does not in the least follow, as the court below infers, that because the statute may apply to a liquidation relating to property held for rental, it *ipso facto* applies to a sale of stock. "In law also the right answer usually depends on putting the right question." *Rogers' Estate* v. *Helvering*, 320 U.S. 410, 413 (1943). The relevant inquiry is not whether a sale should be treated like a liquidation, but whether the stockholder is enabled to realize the gain proscribed by the statute—the gain that Congress intended to tax as disguised ordinary income. If for some reason any doubts remain, they should be completely removed by the committee reports. As the reports expressly explain, section 117(m) includes sales of stock as well as liquidations in order to reach those cases where the use of a corporation raises "the same tax questions" through a sale as through a liquidation. See p. 35, *supra*. And such "same tax questions" are the attempted conversion of ordinary income into capital gain. A sale of stock which produces the same capital gain as if the stockholders had individually owned and sold the property does not remotely involve "the same tax questions" as a conversion of ordinary income through a liquidation.

Professor Surrey, now Assistant Secretary of the Treasury, has well summarized the precise purpose and reach of section 117(m) as it affects sales of stock and liquidations in varying contexts. Collapsible corpora

tions, he writes, are "corporations with assets whose sale by the corporation in the normal course of events would produce appreciable amounts of ordinary income. However, instead of sale by the corporation, the shareholders either sell the corporate stock or liquidate the corporation, *i.e.*, 'collapse' the corporation, and then sell the assets, either route producing only a capital gain." Professor Surrey then considers other situations where a corporation would realize ordinary income "in the normal course of events" through a lease or license rather than a sale of assets. The situation, he states, "may involve a corporation which would under normal operation receive ordinary income from the license or rental of its assets, but which instead liquidates at a capital gain to the shareholders, thus providing a high basis for the shareholders to amortize against their receipt of the license or rental income. Without some special provision to deal with these situations, the ordinary income inherent in many business situations would be converted into capital gain." Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project—American Bar Association Study on Legislative Revision*, 14 Tax L. Rev. 1, 15 (1958).

As this analysis indicates, the design of the statute is to reach gains which "in the normal course of events" or "under normal operation" would be realized as ordinary income. The sole purpose is simply to tax "the ordinary income" so converted, whether the conversion be effected through a sale of stock or a liquidation of the corporation. Congress did not, as the Court of Appeals holds, choose "to use a single statute to deal with" two "types of cases"—sales of stock and liquidations. See p. 70, *supra*. Congress

wrote a single statute to deal with a single case—the realization of ordinary income as a capital gain. And so there is no problem, as the Court of Appeals infers, of engaging in "a two-fold interpretation." *Ibid.* The one question in every case is whether the disposition of the stock produces the gain contemplated by the statute—an attempted conversion of ordinary income. That gain is not produced where the shareholder's profit "would be taxable as a capital gain had he realized it directly rather than through the corporate vehicle." See pp. 58-59, *supra*. The application of the statute turns on the nature or content of the profit realized, just as it does when section 117(a) is involved. See pp. 23, 51-52, *supra*. A determination under section 117(a) "rests primarily on the character of the gain and the relation of the nature of the gain to the nature of the taxpayer's business." The same principle necessarily controls under subsection (m), which simply supplements subsection (a). See pp. 26, 52, *supra*.

At this point it seems appropriate to restate our position on the issue before the Court. Section 117(m) provides that a corporation is collapsible if it is formed or used principally for the construction of property with a view to (1) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise) before the corporation itself realizes a substantial part of the net income to be derived from the property, *and* (2) the realization by the shareholders of gain attributable to the property. It is our position that the gain attributable to the property, which must motivate its construction, means profit which would normally be realized as ordinary income by the corporation, or by the shareholders if they individually owned and operated the property. In some cases the shareholders

may be able to realize this gain through a liquidation. In others they may be able to do so through a sale of stock. But whether a corporation is liquidated or its stock is sold, a corporation is not collapsible within section 117(m) unless, in addition, the shareholders realize the precise gain contemplated by Congress. The fact that a liquidation may produce such a gain is no reason for penalizing a sale which, by the court's own admission, has not produced any such gain. We do not see how this application of the statute, in strict accordance with its legislative history, creates "additional complexities," to which the court mysteriously alludes.

The court's construction comes down to this. It holds that a gain realized on a sale of stock must be treated as ordinary income, even though the gain would clearly be a capital gain if realized on a sale by the corporation itself, or by the shareholders as individual owners of the property. And it does so on the ground that while the sale of stock does not effect a conversion of ordinary income, a liquidation of the corporation might produce such a result. Therefore, a sale should be treated like a liquidation, despite the fact that the results are entirely different. This is, indeed, strange reasoning in the name of a statute designed solely to proscribe tax avoidance. To borrow the language of the Court of Appeals, only under our construction of the statute is it appropriately applied "to the basic fact situations which prompted its enactment." See p. 70, *supra*.

We have yet to consider one other point which the Court of Appeals makes in support of its reasoning. The point relates to the *Ivey* decision, as it applies to sales of stock. Under that decision, the court states, a distinction is drawn between gain attributable to

property held six months or less, and gain attributable to property held over six months. "Thus, any assets which the corporation has acquired within six months and which would be capital assets in the shareholders' hands will produce short-term capital gain while those held longer than six months will produce long-term capital gain." The court then observes: "Regardless of the theoretical wisdom of this approach, it has no basis in the collapsible corporation provision which Congress has enacted. 'One of the clear policy decisions embodied in Section 117(m) and its successor is the treatment of all or none of the gain as long-term capital gain, *i.e.*, the refusal to split the gain between long-term capital gain and ordinary income.'" (R. 37-38.)

The present case, unlike the *Ivey* case, does not involve any such problem of short-term and long-term assets. In any event, here again the Court of Appeals was overly disturbed by a nonexistent problem. The gain reached by the statute is a profit which constitutes a conversion of what would have been ordinary income if realized in the normal course of business. Therefore, to the extent that a profit is a conversion of a short-term gain, it is properly taxable under section 117(m)—assuming, as the statute further requires, that the property was constructed with a view to making a quick sale of stock and realizing such a profit.

The opinion below does not add much by emphasizing that under section 117(m) "all or none of the gain" is treated "as long-term capital gain." There is more to the statute than the opinion indicates. We are referring to the so-called 70-30 rule contained in paragraph (3)(B). This paragraph provides that even if a corporation is collapsible, the statute does not apply

unless over 70 percent of the stockholder's recognized gain is gain attributable to the constructed property. As we have argued, the gain attributable to the constructed property is the gain which constitutes converted ordinary income. Hence, if over 70 percent of the recognized gain is converted ordinary income, the entire amount is taxable as ordinary income—including the portion which otherwise qualifies as a bona fide capital gain. On the other hand, if 70 percent or less is gain which is converted ordinary income, section 117(m) does not apply. The statute, then, specifically contemplates that the amount realized on a sale of stock may consist of both "collapsible" profit and "non-collapsible" profit. In such situations it further contemplates that the Treasury and the courts will determine the precise percentages allocable to each. The case put by the court falls within paragraph (3)(B), just like any other case where an allocation is necessary.

The last paragraph in the opinion below is a revealing commentary on its reasoning. "Although the courts," the opinion states, "must often interpret sections of the Internal Revenue Code in light of their purposes in order to carry out Congressional intent . . . , when this would require the courts to extensively rewrite clear statutory language, the task of revision should be left to Congress. . . ." (R. 38-39.) In the end, then, the Court of Appeals feels obliged once more to fall back upon its "literal" reading of the statute. And this renewed retreat to the "letter" is accompanied by a disclosure which corroborates our analysis of the opinion. Despite its varied efforts to justify its decision, the court rather frankly concedes that it has not interpreted the words of section 117(m) "in light

of their purposes in order to carry out Congressional intent." No matter how circumspectly phrased, this confession speaks for itself. The decision admittedly contravenes the policy and design of the statute. The court seeks to mitigate its unpleasant confession by adding that it cannot rewrite statutes. But there is nothing to rewrite here, just as there was nothing to rewrite in the two decisions which the court cites and tries to distinguish—*Corn Products Co.* v. *Commissioner, supra*; and *Gregory* v. *Helvering, supra*. The only judicial task here is to apply the relevant words of the statute as Congress and also the Treasury meant them to be applied. That task merely requires subsection (m) of section 117 to be construed as subsection (a) is construed—with the same perceptive respect and concern for the purposes of Congress. See pp. 52, 75, *supra*. In failing to discharge that obligation, the Court of Appeals has done the very thing it purports to avoid. It has revised the statute, so that it does precisely the opposite of what Congress so plainly contemplated. See pp. 39-40, 48, 56-59, *supra*.

The opinion below attempts to justify this mutilation of legislative policy by citing this Court's recent decision in *Hanover Bank* v. *Commissioner*, 369 U.S. 672 (1962). That decision, we gather, is supposed to illustrate that a correct construction of statutes may contravene "their purposes" as well as "Congressional intent." The Court of Appeals has clearly misread the *Hanover Bank* decision—which, it so happens, reversed the same Court of Appeals. 289 F. 2d 69 (2d Cir. 1961). The question in that case was whether bond premium was amortizable on the basis of a special call price or a higher general call price. This Court held that the taxpayer had properly computed amorti-

zation by reference to the special call price. It did so after closely examining the legislative history of the statute involved. In sharp contrast to the opinion below, the Court did not resort to a "literal" construction without regard for the purpose of Congress. As the Court summarized its painstaking analysis, "We are bound by the meaning of the words used by Congress, taken in light of the pertinent legislative history. In neither do we find support for the Government's interpretation." 369 U.S. at 682. In view of the legislative history, the Court pointedly concluded that "the Government now urges this Court to do what the legislative branch of the Government failed or elected not to do." *Id.* at 688.

The opinion below is a far cry from the *Hanover Bank* decision. Here the Court of Appeals refused to be bound by the meaning of the words used by Congress, taken in light of the pertinent legislative history.[15] However, the two cases have at least one thing in common. In both the Government has asked this Court to do what neither Congress nor the Treasury set out to do. *Cf. Hanover Bank* v. *Commissioner*, *supra*, at 688.

[15] More recently another panel of the Second Circuit has read the *Hanover Bank* decision more accurately. See *J. C. Penney Co.* v. *Commissioner*, 63-1 U.S.T.C. ¶ 9129 (1962). There the Government argued, in the light of the legislative history, that the statute should not be construed so as to confer a "bonanza" on the taxpayer. Here the Government is arguing, in disregard of the legislative history, that the statute should be construed so as to confer a bonanza on itself. The Government is rarely troubled by such incongruities.

V. The Decision Below Cannot Be Justified By a Later Law. Enacted in 1958. Which Amended the Internal Revenue Code of 1954

We now reach the closing portion of the Court of Appeals' opinion. As a final ground for its conclusion, the court cites a statute enacted eight years after the taxable year involved here. This later statute is section 341(e) of the 1954 Code, an amendment added by section 20 of the Technical Changes Act of 1958, 72 Stat. 1615. The amendment induces the court to reason as follows.

The court states that "regardless of how compatible with the statute" our construction may have been before 1958, "the addition of § 341(e) in that year" makes the construction "anomalous." While this amendment of 1958 "did not completely eliminate the conversion of capital gain into ordinary income by the collapsible corporation provision, it was designed to narrow the imposition of ordinary income treatment in an *Ivey* type of case where the shareholder would have recognized capital gain had he constructed and sold the asset without the use of a corporation." The court then reasons, "if *Ivey* is correct, either § 341(e) is unnecessary or, if it is regarded as overruling *Ivey*, it expands rather than contracts the application of the collapsible corporation provision, clearly the contrary of what Congress intended." (R. 38.)

The Court of Appeals has seriously misconstrued the later action of Congress—even if we erroneously assume, for the moment, that it is otherwise relevant here. If the 1958 amendment proves anything, it clearly confirms that the Treasury has harshly misapplied section 117(m). In this case it is particularly true that "a page of history is worth a volume of logic." *New York Trust Co.* v. *Eisner*, 256 U.S. 345, 349 (1921).

Section 341 of the 1954 Code succeeded section 117 (m) of the 1939 Code. Subsection (e), added in 1958, provides that gain realized on a sale of stock is taxable as capital gain if the so-called "ordinary income" assets of the corporation at the time of sale do not exceed 15 percent of its net worth. Such assets, generally speaking, are properties which would result in ordinary income if sold by the corporation. This provision is elaborated in an extremely intricate statute. It applies only to years beginning after December 31, 1957, but only with respect to sales and liquidations after its date of enactment—September 2, 1958.

The amendment originated in the Senate Finance Committee, which prepared an extensive report on it. Sen. Rep. No. 1983, 85th Cong., 2d Sess. 1, 3, 31, 142 (1958). The Committee stated that the "more significant changes in the bill" were "those concerned with 'unintended benefits' and 'unintended hardships.'" *Id.* at 1. The amendment of section 341 was included among the changes dealing with "unintended hardships" to taxpayers. *Id.* at 3.

The Committee summarized the relevant hardships as follows (*id.* at 31-32):

> "Section 341 of the 1954 Code relates to collapsible corporations. The purpose of this provision, enacted originally in 1950, is to prevent income which would otherwise be taxed at ordinary income tax-rates from being converted into income taxable at capital-gain rates merely by use of the corporate entity. For example, the collapsible-corporation provisions are intended to prevent a taxpayer from transferring inventory items owned by him to a corporation and then selling the stock of the corporation at capital-gain rates to avoid the ordinary income tax which he would have been required to pay if he had sold the inventory directly.

"The collapsible-corporation provisions of present law, however, both by their terms and as interpreted, are so broad that in a number of situations they may have exactly the opposite effect from that intended—instead of preventing the conversion of ordinary income into capital gain, they may instead convert what would otherwise be capital gain into ordinary income. The applicability of the provisions of present law, moreover, depend upon the subjective intent of the parties, a matter which is obviously difficult to determine. Furthermore, if the collapsible-corporation provisions do apply, the entire gain of the shareholder is taxed at ordinary income rates, notwithstanding the fact that had the shareholder not employed the corporate entity a large part of his gain might have been taxed at capital-gain rates. For these reasons, the collapsible-corporation provisions [of] present law frequently impede or prevent legitimate business transactions and in some cases even result in the imposition of ordinary income taxes which would not be imposed if the shareholders of such corporations had not employed the corporate method of doing business."

The Committee next explained why the existing limitations on the statute, "as interpreted," did not eliminate "the problems" with which it was concerned (*id.* at 32):

"For example, in the case of corporations engaged in the development of natural resources, which have continued development activity, the shareholders of such corporations can never be certain that their stock interests in such corporations will not be regarded as stock interests in a collapsible corporation, notwithstanding the fact that their corporations have little or no inventories and that the properties of such corporations (if sold by the corporation or by the shareholders)

would be regarded as properties the sale of which would result in capital gain. *Similarly, real-estate corporations established by investors (as distinguished from dealers) holding rental property for investment only ~~may~~ be regarded as collapsible corporations under present law.*

"... Your committee believes that this amendment is desirable in order to avoid determination of subjective intent in the situations described in this amendment and also to avoid the possibility in this area of the conversion of capital gain income into ordinary income. *Furthermore, it is believed that this amendment will have the effect of removing some of the impediments that presently exist in the case of legitimate business tranactions without permitting the tax avoidance which the collapsible corporation provisions are intended to prevent.*" (Italics supplied.)

The Committee then analyzed the various provisions of the amendment. These were explained as precautionary rules which would prevent stockholders from changing "the character of their income merely by employing the corporate form of doing business. Thus, under these rules, opportunities will not be created for the conversion of ordinary income into capital gain." *Id.* at 33.

Finally, the Committee specifically considered the relation of the amendment to cases not falling within its terms. The amendment, the Committee stated, is "not for the purpose of causing any corporation to be regarded as a collapsible corporation. Your Committee recognizes that there may be legitimate corporate enterprises that will be unable to meet the terms of the limited statutory exceptions" in the amendment.

"Your Committee does not believe that any inference should be drawn from the failure of any corporation, or the failure of any corporation with respect to any of its shareholders, to meet the requirements for any or all of the new statutory exceptions to the application of the collapsible corporation provisions. Accordingly, it is expressly provided that in determining whether any corporation is a collapsible corporation within the meaning of section 341 (b) of the 1954 Code, the fact that such corporation or such corporation with respect to any of its shareholders, does not meet the requirements of any of the new rules shall not be taken into account, and such determination shall be made as if such rules had not been enacted." "Thus, the new subsection merely provides rules under which a corporation may avoid being classified as collapsible; *it will never result in causing a corporation to be classified as collapsible.*" *Id.* at 34, 142. (Italics supplied.) See also Conf. Rep. No. 2632, 85th Cong., 2d Sess. 22-23 (1958).

To complete the picture, we quote the further statement made by Chairman Mills, of the Ways and Means Committee, on the floor of the House (104 Cong. Rec. 17821 (1958)):

> ". . . the purpose of the collapsible corporation rule now contained in section 341 is to prevent what would otherwise be ordinary income from being converted into capital gains. However, because of the breadth of the terms of the section it is being administered and interpreted ~~so as~~ to have the consequence of converting what would otherwise be capital gains into ordinary income. The Senate amendment will correct this in cases falling under its terms."

This later chapter of legislative history does not in any way sustain the conclusion below. On the contrary, it reveals an acute discontent with the Treasury's administration of the statute and further confirms our own interpretation. First, it reaffirms that the purpose of the statute on collapsible corporations is to prevent the conversion of ordinary income into capital gain through the use of a corporate entity. Second, it deplores the fact that as "administered and interpreted," the terms of the statute "may have exactly the opposite effect from that intended—instead of preventing the conversion of ordinary income into capital gain, they may instead convert what would otherwise be capital gain into ordinary income." The Finance Committee severely criticizes "the imposition of ordinary income taxes which would not be imposed if the shareholders of such corporations had not employed the corporate method of doing business." The Committee particularly indicates that real estate corporations, "holding rental property for investment only," may be treated as collapsible corporations, though the resulting gain would be a capital gain if the property were sold by the corporation or by the shareholders. This substantial disparity in treatment is described as an "unintended hardship." Third, the Committee expressly states that no adverse inference is to be drawn against any corporation because it fails to fall within the specific terms of the amendment. In such cases the status of a corporation is to be determined as if the amendment "had not been enacted."

The essence of the matter seems clear. In adding a limited amendment for the future, Congress did not approve the Commissioner's construction for the past. Even if such an amendment might conceivably gen-

erate retroactive implications in other circumstances, no such implication is discernible here. The Finance Committee, as well as the amendment itself, flatly forbid any to be drawn. See p. 85, *supra*. The specific provision to this effect is a special paragraph (11), entitled "Corporations and Shareholders Not Meeting Requirements." This paragraph states that in "determining whether or not any corporation is a collapsible corporation" within the definitional provisions, "the fact that such corporation, or such corporation with respect to any of its shareholders, does not meet the requirements" of subsection (e) "shall not be taken into account, and such determination, in the case of a corporation which does not meet such requirements, shall be made as if this subsection had not been enacted." Int. Rev. Code of 1954, § 341(e)(11). The Court of Appeals' attempted reliance on the 1958 amendment directly contravenes the amendment itself and its authoritative committee report.

The Government's reasoning in regard to the 1958 amendment is quite strange and very simple. The Government generously assumes, in its own behalf, that any legislative change prompted by dissatisfaction with its prior interpretation of the statute is cogent proof that its prior interpretation was correct. Needless to say, the Court has refused to be a party to such imaginative rationalizations.

In *Haggar Co. v. Helvering*, *supra*, the Court dealt with a similar effort to derive a Congressional blessing from a later amendment. The amendment was accompanied by a report which described the prior administrative practice as "unduly restrictive." 308 U.S. at 399. In accordance with his present mode of

reasoning, the Commissioner argued that Congress, through the amendment, had "attributed to the earlier statute the same meaning as that ascribed to it by the administrative construction." By approving an amendment "which would preclude such a construction in the future"—the argument ran—Congress had "also declared that the departmental construction was that intended by the earlier Congress which enacted the statute." *Id.* at 398. The Court, in an opinion by Mr. Justice Stone, quickly disposed of this ingenious contention. "In the face of the legislative expression of dissatisfaction with the earlier statute as construed, Congressional purpose to declare that such was the intended meaning is not to be inferred merely from the fact that the amendment providing for the future said nothing as to the past. If we are to draw inferences it would seem as probable that Congress was content to leave the problems of the past to be solved by the courts where they were then pending, rather than to preclude their solution there." *Id.* at 400.

Mr. Justice Stone's analysis is even more applicable here. The Finance Committee not only disapproved the administrative interpretation as contrary to Congress' purpose, but it declared in so many words, both in the amendment and the report, that no adverse inferences were to be drawn against taxpayers. Even in the future any case that does not fall within the amendment is to be decided as if it had never been enacted. See pp. 85, 87, *supra*.

Indeed, the Commissioner's effort to infer Congressional approval through the amendment borders on the bizarre. The first decision by a trial court, sanctioning the Commissioner's construction of section 117(m), was rendered on April 30, 1957. *Raymond G. Burge*,

28 T.C. 246. See also *Edward Weil*, 28 T.C. 809, and *Arthur Glickman*, 16 T.C.M. 532, both decided on June 28, 1957. The first appellate decision to the same effect was rendered on March 3, 1958. *Burge* v. *Commissioner*, 253 F. 2d 765 (4th Cir.). See also *Weil* v. *Commissioner*, 252 F. 2d 805 (2d Cir.); and *Glickman* v. *Commissioner*, 256 F. 2d 108 (2d Cir.), decided, respectively, on March 6 and June 5, 1958. On July 28, 1958, the Finance Committee filed its report, including the amendment on collapsible corporations. As this rapid sequence graphically shows, the Finance Committee acted with unusual dispatch after the initial appellate decisions applying section 117(m) to the sale of rental property held for investment. To find Congressional approval of the past here is simply to ignore what Congress has said and done. The very purpose of the 1958 amendment was to prevent the construction which the Commissioner is now zealously pursuing. Cf. *Helvering* v. *New York Trust Co.*, *supra*, at 468-469; *United States* v. *Laws*, 163 U.S. 258, 265-266 (1896); *Levindale Lead & Zinc Mining Co.* v. *Coleman*, 241 U.S. 432, 439 (1916). The amendment did not declare a new policy. It was "a more explicit expression of the purpose" of the original statute, compelled by the Commissioner's application of that statute. Cf. *Jordan* v. *Roche*, 228 U.S. 436, 445 (1913); *Haggar Co.* v. *Helvering*, *supra*, at 400. The Commissioner is trying very hard to make a virtue of his own error. Through some peculiar process of reasoning he has concluded that his construction must have been correct because Congress promptly disapproved it.

Even within the terms of its own reasoning, the opinion below leaves much to be desired. The Court of Appeals states that "regardless of how compatible with

the statute the *Ivey* interpretation may have been previous to 1958," the enactment of section 341(e) in that year made the interpretation "anomalous." See p. 81, *supra*. But if section 341(e) created the anomaly, then there was no anomaly until 1958—or eight years after the taxable year involved here. The present case turns on the statute as it stood in 1950, not on the statute as it may have been affected long afterward by an amendment. In fact, the 1958 amendment itself states that it applies only prospectively. Moreover, the amendment was an addition to section 341 of the 1954 Code—not section 117(m) of the 1939 Code, which is the controlling statute here. Section 341 was enacted as part of a comprehensive new Code. Even if the court's reasoning, on some theory, were possibly relevant as a retroactive gloss on section 341, it cannot in any way affect section 117(m). In 1950, when section 117(m) was enacted, Congress was necessarily unaware of the construction later attributed to it by the Commissioner. The question here is what the legislative draftsmen intended in 1950—not in 1954. Each statute in each Code must be interpreted in the light of its own legislative history. *Commissioner* v. *Bilder*, *supra*, at 504-505. The Treasury itself has succinctly stated the answer. The legislative history of section 117(m) "makes it clear that the objective was to prevent the successful use of a device for converting ordinary income into long-term capital gain through the medium of a corporation." Rev. Rul. 56-60, *supra*, at 175-176.

Finally, quite apart from the special considerations involved here, the 1958 amendment and the related committee report cannot cast any retroactive implica-

tions in the Commissioner's favor. Later legislative history—whether it be reflected by committee reports or other materials—is not relevant evidence of what a prior statute means. See *Penn. Mutual Co.* v. *Lederer,* 252 U.S. 523, 538 (1920); *Okla. Press Pub. Co.* v. *Walling,* 327 U.S. 186, 197, n. 20 (1946); *Fogarty* v. *United States,* 340 U.S. 8, 13-14 (1950); *United States* v. *Turley,* 352 U.S. 407, 415, n. 14 (1957). The backward use of later committee reports "would amount to retroactive amendment by committee report, a step in construction by reference to 'prospective legislative history' not heretofore taken." *Okla. Press Pub. Co.* v. *Walling, supra,* at 197, n. 20. As the Chief Justice recently wrote of another effort to obtain "succor" from later legislative activity, "statutes are construed by the courts with reference to the circumstances existing at the time of passage." How a later Congress may have understood an earlier statute "is not of weight" in construing the earlier one. *United States* v. *Wise,* 370 U.S. 405, 411, 414 (1962). See also *United States* v. *Price,* 361 U.S. 304, 313 (1960). And only this Term the Court stated, without deeming it necessary to cite any supporting decisions, that "subsequent legislative materials are neither appropriate nor relevant guides to interpretation of prior enactments." *Federal Trade Commission* v. *Sun Oil Company,* No. 56, January 14, 1963. The obligations of a taxpayer for a particular year stem from the statutes passed by Congress for that year—not from *ex post facto* observations, through a report or otherwise, made on some later occasion. Nothing that was said in 1958 can change the legislative purpose and policy expressed in 1950. See *Penn. Mutual Co.* v. *Lederer, supra,* at 538; *United States* v. *United Mine Workers,*

330 U.S. 258, 282 (1947); *Fogarty* v. *United States*, *supra*, at 14.[16]

Insofar as the amendment itself is concerned, the Commissioner's position is no better—even if the 1958 amendment, contrary to its own terms, is regarded as some attempted gloss upon the statute enacted in 1950.[17] A later amendment cannot give a statute enacted earlier "a different meaning from what it then acquired." *Gemsco, Inc.* v. *Walling*, 324 U.S. 244, 265 (1945), involving an amendment enacted two years later. Congress' later "interpretation as such is immaterial. It is as likely to be wrong as anyone else, and in the end the courts must decide." *Fire Companies Bldg. Corp.* v. *Commissioner*, 54 F. 2d 488, 489 (2d Cir. 1931). See further *Gilbert* v. *Thierry*, 58 F. Supp. 235, 242 (D. Mass. 1944), *aff'd*, 147 F. 2d 603 (1st Cir. 1945), stating that "the use of an amendatory statute to interpret the original statute is contra-canonical." At most a later statute can only indicate what a later Congress may have thought. It sheds no light on what an earlier Congress contemplated or intended. See *Higgins* v. *Smith*, 308 U.S. 473, 479-480 (1940); *Rainwater* v. *United States*, 356 U.S. 590, 593 (1958). *Cf. Haggar Co.* v. *Helvering*, *supra*, at 400.

Under our system of law it cannot be otherwise. "The interpretation of the meaning of statutes, as ap-

[16] *Cf. Commissioner* v. *Acker*, 361 U.S. 87, 92-93 (1959), which dealt with committee reports accompanying a prior act. There the Court declared invalid a regulation embodying a statement contained in reports relating to "the forerunner of the section" involved, "and not to that section itself" enacted eight months later.

[17] However, as we have noted, the 1958 statute did not amend the statute enacted in 1950. See p. 90, *supra*.

plied to justiciable controversies, is exclusively a judicial function." *United States* v. *American Trucking Assns., supra*, at 544. Well over 150 years ago an attorney argued before this Court that a later act "could not alter the past law, and make that to have been law which was not law at the time. To declare what the law is, or has been, is a judicial power; to declare what the law shall be, is legislative. One of the fundamental principles of all our governments is, that the legislative power shall be separated from the judicial." The Court considered this statement of principle so clear and settled, that it "stopped the counsel, observing that it was unnecessary to argue that point." *Ogden* v. *Blackledge*, 2 Cranch 272, 277 (1804). See *Town of Kashkonong* v. *Burton*, 104 U.S. 668, 678-679 (1882); *United States* v. *Wise, supra*, at 414. "The utmost effect to be given to a subsequent legislative declaration" is "to regard it as an alteration of the existing law in its application to future transactions." *Town of Kashkonong* v. *Burton, supra*, at 679. As Chief Justice Marshall declared, "a legislative act founded on a mistaken opinion of what was law, does not change the actual state of the law as to pre-existing cases." *Talbot* v. *Seeman*, 1 Cranch 1, 35 (1801). In his pursuit of the present deficiencies the Commissioner is blissfully unaware of what was already well settled in the early years of this Court.

The crux of the Court of Appeals' position may be simply stated. The court has held that Congress' action, taken in 1958, has retroactively affected the meaning of section 117(m), enacted in 1950. If this conclusion is correct, despite all our arguments to the contrary, it necessarily raises grave constitutional issues. First, the conclusion assumes that Congress

may constitutionally exercise the power of construing statutes—a power which "is exclusively a judicial function." Second, the conclusion further assumes that Congress may retroactively increase tax liabilities, after the lapse of eight years, without violating the due process clause of the Fifth Amendment. *Cf. Haggar Co.* v. *Helvering, supra,* at 400; *Claridge Apartments Co.* v. *Commissioner,* 323 U.S. 141, 164-165 (1944). Apparently the Commissioner is untroubled by such questions.

VI. The Government's Application of Section 117(m) Violates the Standards of Responsible Tax Administration

We have completed our analysis of the Commissioner's position and the opinion below. However, our discussion would be incomplete if we failed to consider a more basic issue which underlies the question of construction before the Court. That issues radiates well beyond the confines of this case. It goes to the very essence of tax administration in our democratic society.

As the Government itself has repeatedly stated, the purpose of section 117(m) was to prevent taxpayers from obtaining a special tax benefit through incorporating an enterprise. That benefit consists of realizing as a capital gain what would have been ordinary income in the normal course of business if the stockholders had owned the property directly or the corporation itself had realized the income. Here, concededly, if the stockholders themselves had owned and sold the development, the profit on the sale would have been a capital gain. Again, if the corporations had sold the development, the profit would have also been a capital gain. See pp. 38-39, *supra*. Nevertheless the Government is assiduously contending that the

same profit realized through a sale of stock is ordinary income. A statute solely designed to prevent a conversion of ordinary income into capital gain is boldly applied so as to produce a conversion of capital gain into ordinary income. The Government, in short, has turned the statute upside down. In the process of supposedly construing the statute, it has emerged with a travesty of the statute. Good sense is turned into nonsense—under the alleged authority of those who made good sense. The sum and substance of the matter is that taxpayers are punished for the apparent misdeed of having owned property through a corporation rather than as individuals. See pp. 56-59, *supra*. Section 117(m) was proposed and enacted in order to correct gross "inequities". See p. 27, *supra*. As the Government reads and applies the statute, Congress decided to replace one inequity with another.

This kind of administration brings us to the more basic issue which this case unfortunately raises. May the Treasury disregard legislative hearings and committee reports which clearly disclose the intended meaning and scope of tax legislation entrusted to its fair administration? May it close its eyes and ears to the plainly expressed policy of a statute, and proceed to improvise a policy of its own by reading the words to suit itself? These questions involve no less than the integrity of the administrative process in our tax system. It is often said that taxpayers have an ethical responsibility to the Treasury. But as this case illustrates, it is not always remembered that the Treasury has an ethical responsibility to taxpayers—and to Congress, too. A department of Government which constantly exhorts taxpayers to be guided by standards of moral excellence should gladly serve as a model in applying those same canons of behavior.

Under our Constitution the taxing power is entrusted solely to Congress. Tax policy is made by Congress in the continuous give-and-take of the democratic process. This scheme of things reflects a painful lesson of history—that of all powers exercisable by government, the power to tax is probably the most susceptible to administrative abuse. The only function of the Treasury is to consummate the purposes of Congress. The Treasury "can add nothing to income as defined by Congress," though it may firmly feel that the definition could be improved. *M. E. Blatt Co.* v. *United States*, 305 U.S. 267, 279 (1938). There is no taxation without legislation. Any tax "asserted by the Commissioner" must be "authorized by Congress." *Helvering* v. *Griffiths*, 318 U.S. 371, 394 (1943). We have no desire to criticize the energetic enforcement of our tax laws. But enforcement goes well beyond its allotted province when it ignores the unmistakable purposes of Congress. At that point, it is simply an obvious effort to collect as much tax as possible, without due respect for the wishes of Congress.

This case unhappily reveals that kind of administration. For we have here a steadfast refusal to pay attention to an unmistakable legislative purpose—a purpose to which the Treasury itself significantly contributed. First the President carefully indicated the scope of the requested statute. Next the Secretary of the Treasury elaborated upon the proposal before the Ways and Means Committee. Then the General Counsel of the Treasury analyzed the proposal further in response to searching questions. The hearings were followed by House and Senate committee reports. These reports clearly summarized anew the precise purpose

and reach of the statute. And then the same summary was largely repeated in a separate report prepared by the Staff of the Joint Committee on Internal Revenue Taxation. Moreover, the Staff of the Joint Committee helped prepare the Memorandum which the Treasury submitted to the Ways and Means Committee. See pp. 27-35, *supra*. If there was ever a thorough legislative history articulating Congress' policy, this is it. Yet the Treasury has gone ahead as if there were no such history and policy. It has refused to see what anyone can see who would apply the statute as Congress intended. It asks this Court to construe the statute in blinkers.

When the statute was enacted in 1950, no one in Congress or the Treasury even slightly suggested any such liability as the Commissioner is now asserting. If a taxpayer and his attorney studied the hearings, they were informed that the gain to be taxed under the statute was ordinary income converted into capital gain. If they consulted the committee reports, their understanding of the statute was fully confirmed. It would, indeed, be a sad reflection on our tax system and the Treasury if taxpayers could not rely on a unanimous expression of views voiced by the President, the Secretary of the Treasury, the General Counsel of the Treasury, the House Ways and Means Committee, the Senate Finance Committee, and the Staff of the Joint Committee on Internal Revenue Taxation. The position now taken by the Government is completely at odds with all these official statements on the statute. "Not one contemporaneous word in or out of Congress discloses the purpose which the Government says we should find that this legislation accomplished." Cf. *Helvering* v. *Griffiths*, *supra*, at 378, 389.

What the Court said in another context is especially pertinent here. "Always a taxpayer is entitled to know with fair certainty the basis of the claim against him." *General Utilities Co. v. Helvering*, 296 U.S. 200, 206 (1935). One of the very reasons for printing committee hearings and reports is to make that necessary knowledge available to him. Today, when tax legislation has become unbelievably complex, they are well-nigh indispensable. Hearings and reports are meant to be read and studied by taxpayers and their advisers. They are a significant means of providing that "fair certainty" to which taxpayers are surely entitled. They illuminate words which would otherwise "dance" before the eyes "in a meaningless procession." Hand, *Thomas Walter Swan*, 57 Yale L. J. 167, 169 (1947). Since hearings and reports are an important source of reasonable expectations, they are also designed to serve as guides to the Treasury and the courts in applying the statutes to which they relate. If the Treasury may quietly disregard relevant hearings and reports, then they are essentially delusive snares laid for taxpayers and their advisers. It would be much better if they were left unpublished.

After the President sent his message, both the Secretary of the Treasury and the General Counsel of the Treasury appeared before the Ways and Means Committee. There they both delineated the special purpose and scope of the legislation. Now the Treasury would prefer to forget the hearings. It would ignore not only the message of the President and the reports of both tax committees, but also its own repeated assurances on the precise reach of the statute—assurances given by the head of the Treasury and another high-ranking official. Again and again, under close ques-

tioning, the Treasury emphasized to Congress that the statute would apply only to corporations used "for the particular purpose of carrying out what we would characterize as tax avoidance"—the avoidance of ordinary tax on the ordinary income from the property—so that "the Treasury may, instead of assessing the capital gains rate, assess the regular income tax rate on the individual." At the same time the Treasury stoutly insisted that it had no desire to affect corporations which operate in normal fashion, paying the ordinary tax on ordinary income. See pp. 31-34, *supra*. It was on the basis of these repeated assurances, given after full consideration of the evils involved, that Congress acted. For that matter, substantial portions of the reports are mere echoes of statements made by the Treasury. Judicial respect for the administrative process presupposes a faithful effort to carry out the policy of Congress. The Treasury here attributes its conclusion to the policy of Congress, while persistently ignoring the legislative data which express that policy. In effect, the Treasury says: We see what you are driving at, but we shall go on as if we do not. Cf. *Johnson* v. *United States*, 163 Fed. 30, 32 (1st Cir. 1908); *United States* v. *Hutcheson*, 312 U.S. 219, 235 (1941).

The Treasury should not be allowed to slight committee reports and its considered assurances before tax committees. Reports and hearings are not to be respected or ignored, depending on whether they sustain the taxpayer or the Treasury. Taxpayers should not be told one thing while legislation is being passed, and then something quite different after it is passed. Taxes are onerous enough without such administrative behavior. In these days of high rates, it is all the more urgent that the Treasury be obliged

to abide by its professions and assurances. The Treasury's action would have been sufficiently grave if it had simply disregarded the legislative history of 1950. But here the Treasury has adopted a flexible approach which is even more revealing. It pays no attention to the legislative history of 1950, and then falls back on what happened eight years later in response to its own misconstruction of the statute. See p. 87, *supra*.

Of course, we have by no means exhausted the Treasury's sustained elasticity. While the Treasury invokes the legislative history of 1958, it completely ignores Congress' explicit admonition that this later history is not to be taken into account. As the Finance Committee stated, the amendment of 1958 "will never result in causing a corporation to be classified as collapsible." See p. 85, *supra*. Again, while the Treasury faithfully abides by the policy of Congress in applying section 117(a), it nicely disregards that policy in applying section 117(m). Different standards of interpretation are used, although both statutes are concerned with the same problem. So-called "literal" meanings generally count only when they happen to favor the Treasury. And all this twisting and turning is methodically attributed to Congress.

If the Treasury has changed its mind since 1950, then the answer is fairly obvious. It should repair to Congress for new legislation, not to this Court. If the Treasury feels that profit which normally constitutes a bona fide capital gain should be taxed as ordinary income merely because an enterprise is incorporated, "such a determination of policy in the administration of the income tax law should be made

by Congress, which maintains a Joint Committee on Internal Revenue Taxation charged with the duty of investigating the operation of the federal revenue laws and recommending such legislation as may be deemed desirable." *United States v. Nunnally Investment Co.*, 316 U.S. 258, 264 (1942).

Mr. Justice Douglas' words in *Commissioner v. Lester*, 366 U.S. 299, 306-307 (1961), are a fitting observation on the Government's present administrative behavior. "The revenue laws have become so complicated and intricate that I think the Government in moving against the citizen should also turn square corners." "Resort to litigation, rather than to Congress, for a change in the law is too often the temptation of government which has a longer purse and more endurance than any taxpayer." Here, we may appropriately add, the proposed change does not even have the excuse of good sense. President Truman requested the legislation of 1950 in order "to improve the fairness of the tax system." See p. 27, *supra*. The Treasury itself hardly contends that its position contributes much to that objective. Whatever the differences between the Second and Fifth Circuits, they both agree on one thing —that the tax asserted here produces an unreasonable result. The Second Circuit calls it "unwarranted"; the Fifth Circuit, "nonsense".

In describing the responsibilities of tax administration, the Commissioner has stated, "We want to avoid overzealousness or creating an adversary climate. We want fairness and objectivity." Caplin, *Responsibilities of the Tax Adviser—A Perspective*, 40 Taxes 1030, 1031 (1962). These are well-chosen words, with which

no one can quarrel. But they acquire meaning and content only as they are genuinely applied. The Government's administration of section 117(m) is an essay in "overzealousness," rather than the "fairness and objectivity" to which Congress and taxpayers are entitled. At the very least a fair and objective execution of the tax laws requires the Government to keep faith with Congress and those to whom Congress has addressed its laws. We regret to say that in our view the Government's administration of section 117(m) has not approached that standard of performance. We hope that tax administration will never reach the point where "it is not enough to attain to a degree of precision which a person reading in good faith can understand; but it is necessary to attain if possible to a degree of precision which a person reading in bad faith cannot misunderstand." *In re Castioni* [1891], 1 Q.B. 149, 167.

CONCLUSION

For the foregoing reasons the decision of the Court of Appeals should be reversed and the deficiencies should be expunged.

Respectfully submitted,

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APPENDIX

Internal Revenue Code of 1939:

Sec. 117. Capital Gains and Losses.

(a) [as amended by Sec. 210(a) of the Revenue Act of 1950, 64 Stat. 932] *Definitions.*—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business) but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or real property used in his trade or business;

* * * *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income;

(b) [as amended by Sec. 150(c) of the Revenue Act of 1942, 56 Stat. 843] *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than six months.

(c) [as amended by Sec. 301(c)(3) of the Revenue Act of 1950, 64 Stat. 953] *Alternative Taxes.*—

* * * *

(2) *Other taxpayers.*—If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12 . . . a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 50 per centum of such excess.

* * * *

(j) [as amended by Sec. 210(b) of the Revenue Act of 1950, 64 Stat. 933] *Gains and losses from involuntary conversion and from the sale or exchange of certain property used in the trade or business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. . . .

* * * *

(2) *General rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets

held for more than 6 months into other propery or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. . . .

* * * * *

(m) [as added by Sec. 212(a) of the Revenue Act of 1950, 64 Stat. 934] *Collapsible Corporations.*—

(1) *Treatment of gain to shareholders.*—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) *Definitions.*—

(A) For the purpose of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

(ii) the realization by such shareholders of gain attributable to such property.

(B) For the purposes of subparagraph (A), a corporation shall be deemed to have manufactured, constructed, or produced the property if—

(i) it engaged in the manufacture, construction, or production of such property to any extent,

(ii) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, or produced the property, or

(iii) it holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, or produced by the corporation.

(3) *Limitations on application of subsection.*—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning (more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; and

(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production.

For purposes of subparagraph (A), the ownership of stock shall be determined in accordance with the rules prescribed by paragraphs (1), (2), (3), (5), and (6) of section 503(a), except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses of that individual's brothers and sis rs (whether by the whole or half blood) and the spouse f that individual's lineal descendants.

*   *   *   *

(26 U.S.C. 1952 ed., Sec. 117.)

INDEX

CITATIONS

Miscellaneous—Continued

In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 476

BENJAMIN BRAUNSTEIN, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (A. 184–281)[1] is reported at 36 T.C. 22. The opinion of the court of appeals (R. 21–39) is reported at 305 F. 2d 949.

JURISDICTION

The judgments of the court of appeals were entered on July 6, 1962 (R. 39–41). The petition for a writ of certiorari was filed on October 1, 1962, and was

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[1] "A." refers to the appendix to petitioners' brief in the court of appeals, of which nine copies were filed with the petition for certiorari. Because of its length and the irrelevancy, in view of the limited grant of certiorari, of many of its findings, the Tax Court's opinion was not reprinted in the record in this Court. The "A." references in this brief are solely to that opinion.

granted on December 10, 1962 (R. 42). The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

QUESTION PRESENTED

Section 117(m) of the Internal Revenue Code of 1939 provides that, if stockholders use a corporation to construct property and then, as planned, promptly sell their stock in order to realize in the form of stock proceeds the "gain attributable to such property," their gain is to be taxed as ordinary income. The question presented is whether the application of that provision is dependent upon a finding in each case that there was no other way for the stockholders to convert the values created by the construction into capital gain.

STATUTE AND REGULATIONS INVOLVED

Section 117(m) of the Internal Revenue Code of 1939 and § 29.117-11 of Treasury Regulations 111 (1939 Code) are set forth in part at pp. 39-48, *infra.*

STATEMENT

Petitioners Benjamin and Harry Neisloss are builders; petitioner Braunstein, an architect. The three petitioners[2] became associated in 1938 and thereafter joined in a series of construction ventures, usually through corporations the stock of which they owned equally (A. 186-187).

In February 1948, the petitioners obtained a commitment from the Federal Housing Administration, under § 608 of the National Housing Act, to insure

[2] Their wives are parties only by virtue of the filing of joint returns.

mortgage loans for the construction of a multiple-dwelling garden-type apartment project. The project was to be carried out by two corporations, Springfield Development Company, Inc. (480 apartment units), and Hill Development Company, Inc. (224 units). (A. 189–190.) The transactions involving the two corporations were identical in all aspects material here, however, and for simplicity we will confine the statement of facts, and the discussion in the Argument, to those involving Springfield.

The FHA[3] estimated the cost of the Springfield project as follows (A. 192–195, 198):

On-site construction costs	$4,002,959	
Builder's fee (5%)	200,148	
Architect's fee (5%)	210,155	
Subtotal		$4,413,262
Off-site construction costs (sewers, streets, etc.)	$101,443	
Subtotal		$4,514,705
Financing fees, carrying charges during construction, legal and organizational expense	$270,442	
Total		4,785,147

Based on those estimates, the FHA agreed to insure a mortgage in the amount of $4,174,800, an amount basically determined[4] as 90% of the total estimated costs exclusive of off-site construction ($4,785,147 less $101,443, or $4,683,704) (A. 194).

Springfield was organized on March 31, 1948, to carry out the approved project. Ten shares of common stock were issued to each of the three petitioners

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[3] The estimates made by petitioners in their application for loan insurance were somewhat higher (A. 191).

[4] A discrepancy of some $40,000 is attributable to an adjustment required because of the lack of fee ownership of the land (see A. 194).

for $1 per share, for a total capital contribution by them of $30.[5] (A. 199.)

To perform the construction work, the petitioners formed, with equal shares, a partnership known as the N.B. Construction Company.[6] The partnership originally executed a contract to perform all of the on-site construction work for the corporation for a cash price of $4,002,959 (*i.e.,* the FHA's estimated cost) plus a 5% builder's fee to be paid in stock (A. 201–202). Petitioner Braunstein similarly contracted to perform the architectural services for a 5% fee to be paid in stock (A. 203). The builder's and architect's fees were, however, contemporaneously waived and it was never intended that they should be paid (A. 202–203). The formal lump-sum construction contract was apparently also never meant to be enforced, and the partnership in fact performed the work on a cost-reimbursement basis. The partnership similarly performed the off-site work, for which no formal contract was ever made, on a cost basis (A. 204, 205). The total cost to the partnership of both the on-site and the off-site construction work was $3,807,908, and it charged only that amount to the corporation (A. 222). Since it charged only for its out-of-pocket costs, the partnership reported no taxable income from the construction (A. 205).

[5] Pursuant to FHA regulations, 100 shares of $1 par value preferred stock were issued to the FHA for $100 in cash (A. 199).

[6] The work was initially to be done by a corporation, but the partnership took over almost immediately (A. 201–202, 204–205).

The work performed by the partnership (including the services of petitioner Braunstein as the nominal architect) for a total price of $3,807,908 had been estimated by the FHA to cost $4,514,705,[7] or $706,797 more than the actual cost. The nonpayment of the estimated builder's ($200,148) and architect's ($210,155) fees accounted for $410,303 of the savings. The additional savings were attributable largely to the fact that the partnership did not (as the estimates had assumed the builder would) contract out the carpentry, plumbing, and heating work but performed the work itself, thereby effectively eliminating from the costs the subcontractors', as well as the builder's and architect's, normal mark-up (A. 227–228).[8]

Besides the savings of $706,797 realized by the corporation in its dealings with the partnership, the amounts spent by the corporation for carrying charges during construction (interest, taxes, insurance), financing costs (FHA fees for mortgage insurance and inspection, etc.; title and recording fees; etc.), and for legal and organization expenses turned out to be $9,342 less than estimated ($261,100 instead of $270,442) (A. 193–194, 224).

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[7] Direct on-site construction costs, $4,002,959; builder's and architect's fees, $410,303; off-site construction, $101,443 (A. 192–195, 198).

[8] For both Springfield *and* Hill, the savings on carpentry were estimated at $80,000 and on plumbing and heating, at $85,000 (A. 227). Declining lumber prices also produced an unexpected savings of $50,000 for the two projects (A. 228). Since the partnership's construction costs were allocated about 68% to Springfield ($3,807,908) and 32% to Hill ($1,757,581), the savings were presumably realized in the same proportion (A. 222).

In all, the total estimated cost for construction, financing and carrying costs was $4,785,147 while the cost actually incurred was $4,069,008 (A. 224), effecting a total savings over the estimates of $716,139. The amounts actually expended ($4,069,008) were in fact less by $105,792 than the proceeds of the insured mortgage loan ($4,174,800), with the construction thus being financed entirely from the loan proceeds.

Construction of the buildings, which had begun in April 1948, was completed on varying dates from September 1948 to June 1949, and by September 1, 1949, all units were occupied (A. 204, 206–207).

On June 8, 1950, the petitioners entered into an agreement to sell their 30 shares of common stock in Springfield to one Penzell. The agreement provided, in effect, that the corporation would first make a distribution of $410,000 to the petitioners and that they would then convey the stock to the buyers for a further payment of $273,500. The agreement was executed substantially according to its terms. On June 30, 1950, the board of directors of Springfield increased the book value of the buildings by $750,000 (to accord approximately with the FHA's original estimate) and declared a dividend of $410,000 on the common stock. The dividend was paid to petitioners on August 25, 1950 (A. 243–245).[9] After several postponements for the convenience of the buyers, the stock was transferred to them on November 13, 1950, for the agreed-upon price (with minor adjustments not relevant here) (A. 249-250).

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[9] Payment of the dividend was effected primarily by the corporation's cancellation of a debt owed it by the partnership for advances (A. 246–247).

We agree with petitioners (Br. 39, n. 8) that the corporation's distribution of $410,000 followed by the sale of the stock for $273,500 was substantially equivalent in consequence, under the circumstances of this case, to an outright sale of the stock for $683,500 paid directly by the buyers.[10] In the discussion in this brief, therefore, we will for simplicity ignore the separate character of the distribution and treat the entire $683,350 as having been received by the petitioners directly from the buyers.

Each petitioner reported his one-third share of the proceeds, less his $10 basis and expenses of sale, as a long-term capital gain.[11] The Commissioner as-

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[10] Since the corporation had no earnings or profits, there is no question of dividend treatment, and the distribution would therefore be treated for tax purposes as an amount received upon sale or exchange of the stock. That is true both generally (see § 115(d)) and for purposes of the collapsible-corporations provisions involved here (see § 117(m)(1); Treas. Regs. 111, § 29.117-11(a), *infra*, p. 41).

[11] For the second corporation, the Hill Development Company, Inc., the estimated and actual costs were (A. 209-214, 222, 226):

	Estimated	*Actual*
1. On-site construction	$1,848,176	
2. Builder's fee (5%)	92,409	
3. Architect's fee (5%)	97,029	
4. Off-site construction	47,339	
5. Subtotal	$2,084,953	$1,757,581
6. Financing, etc	124,486	115,253
7. Total	$2,209,439	$1,872,834

The difference between the estimates and the actual cost for the work performed by the petitioners (line 5) was $327,372. From their Hill stock, which they similarly sold to Penzell, petitioners realized a total of $271,500, of which $145,000 was a distribution from the corporation and $126,500 was paid directly by the buyers (A. 243-245). They treated their gain in the same way as that from the Springfield stock.

d a deficiency treating the gain as ordinary in- (A. 250–252). The Tax Court upheld the de- ncy, holding that Springfield was a "collapsible oration" as defined in § 117(m)(2) of the Internal enue Code of 1939 and that petitioners' gain was rdingly taxable as ordinary income under § 117 (1) (A. 184–281). The decision was reviewed by ull Tax Court, with Judge Kern dissenting. The rt of Appeals for the Second Circuit affirmed 21–39).

SUMMARY OF ARGUMENT

a corporation is formed for the "manufacture, truction, or production of property" and the kholders, through a quick sale of their stock ned for that purpose, realize gain more than 70% hich is "attributable to the property so manufac- l, constructed, or produced," the gain is, under (m) of the 1939 Code, taxable as ordinary in- . It is not open to question here that the peti- ers' sale was planned, and it is agreed that the zed value of their stock reflected but the excess ne value of the buildings over their construction To that extent, it is undisputed that the gain sought and realized by petitioners was "attrib- le" to the buildings. If that is the sole meaning ne "gain attributable to" phrase, the gain was tax- as ordinary income.

espite the natural reading of "gain attributable as looking only to the source or cause of the gain l the essential function it performs given that

meaning), petitioners contend that it ought to be so read as to limit the application of the statute to gains which would have been taxable as ordinary income had the stockholders constructed and sold the buildings without the use of a corporation. Such a reading is required, they say, to confine the statute to its evident purpose—namely, to prevent the conversion of ordinary income into capital gain.

However freely the question of interpretation is approached, the words of the statute are quite incapable of carrying the meaning petitioners would give them. Moreover, the implied limitation petitioners would read into the statute conflicts with the regulations; is contrary to the settled assumptions of commentators, litigants, and the courts for many years; and would make a nullity of an express, and much narrower, limitation later added by Congress.

In any event, no limitation need be supplied to confine the statute to its admitted purpose of preventing the "conversion" of ordinary income into capital gain. The very terms of the statute limit its application to gain which, although in the form of stock proceeds, represents a realization of values created by the "manufacture, construction or production of property." Each of those is a value-creating process, the fruits of which obviously ought to be, and normally are, taxed as ordinary income.

In this case, the conversion of ordinary income is blatant. Petitioners, having contributed $30 for their stock, were able two years later to dispose of it for

$683,500 for only one reason: by charging the corporation nothing for architectural, general contracting, and subcontracting services estimated to cost over $700,000, they had created for the corporation buildings worth $683,500 more than their actual cost. In short, petitioners contributed their services to create a valuable property for the corporation and then realized upon that value by selling their stock. If compensation for services be the prime example of ordinary income, petitioners' gain—simply a realization in another form of the compensation they should have been paid for their construction services—is a prime example of converted ordinary income.

Petitioners assert, however, that they could successfully have converted the value of their services into capital gain by constructing and selling the buildings as individuals. Assuming that to be so, it proves only that loopholes remain, not that the Court should reopen the one Congress closed. Nothing suggests that the application of § 117(m) was meant to depend upon how some alternative transaction would be taxed, much less the particular alternative tendered by petitioners. Had the corporation paid petitioners for their services, the gain would undeniably have been taxed as ordinary income, and petitioners give no reason why that alternative should be any less determinative of the "true" nature of the gain than the one they offer.

ARGUMENT

SECTION 117(m) OF THE INTERNAL REVENUE CODE OF 1939, MAKING GAIN FROM THE SALE OF STOCK IN A "COLLAPSIBLE CORPORATION" TAXABLE AS ORDINARY INCOME, IS SELF-CONTAINED; ITS APPLICATION IS NOT DEPENDENT UPON A DETERMINATION THAT THERE WAS NO OTHER WAY FOR THE TAXPAYER TO HAVE CONVERTED HIS PROFITS FROM CONSTRUCTION INTO CAPITAL GAIN

I

THE STATUTE IS APPLICABLE BY ITS TERMS

Section 117(m)(2)(A) of the Internal Revenue Code of 1939[12] defines a "collapsible corporation" as:

> * * * a corporation formed or availed of principally for the manufacture, construction, or production of property * * * with a view to—
>
> (i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation * * * of a substantial part of the net income to be derived from such property, and
>
> (ii) the realization by such shareholders of gain attributable to such property.

If a corporation is collapsible, then any gain realized by a holder of more than 10% of the stock from a stock sale or corporate distribution within three years of the completion of the property is to be taxed as

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[12] Except as otherwise indicated, all section references are to the Internal Revenue Code of 1939 as amended by the Revenue Act of 1950, 64 Stat. 932, the form in which it stood on the relevant dates. The later amendments are indicated at p. 21, n. 21, *infra*.

ordinary income (§ 117(m) (1) and (3)), except that—

> this subsection shall not apply to the gain recognized [by a shareholder] during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; * * * [§ 117(m)(3)(B)].

It is admitted that each petitioner owned more than 10% of the stock; that their gains were realized within three years; and that the corporation was formed "principally for the * * * construction * * * of property." It is also not open to question that, during the construction of the buildings, the petitioners contemplated (*i.e.,* had "a view to") selling their stock shortly after construction was completed (*i.e.,* "prior to the realization by the corporation * * * of a substantial part of the net income to be derived from such property"). The Tax Court so found; the court of appeals affirmed the finding; and this Court, limiting the grant of certiorari (R. 42), declined to review the question.

The controversy, so far as it relates to any words in the statute, concerns solely the "gain attributable to" phrase, which appears, with admittedly the same meaning (Br. 77–78), both in the definition of a collapsible corporation (§ 117(m)(2)(A)(ii)) and in the limitation on stockholder taxability (§ 117(m)(3)(B)). A corporation is not collapsible unless the object of the stockholders' planned sale is to realize "gain attributable to [the property manufactured, constructed, or produced]", and a stockholder is not

taxable unless more than 70% of the gain he actually realizes is so attributable. Thus, the only gain of a shareholder that the statute ever seeks to tax as ordinary income[13] is gain that is attributable to, or a realization upon the value of, property which the corporation has created by manufacture, construction, or production, and the stockholders must both seek and realize such gain for the statute to apply.

Here, there is no dispute that the gain the petitioners realized is the gain they sought. The question, therefore, goes not to the state of mind of the petitioners but to the proper characterization of the gain they actually realized. If that gain was, in the words of the stockholder-taxability limitation, "attributable to the property so manufactured, constructed, or produced," it equally follows, since the gain realized was that anticipated, that the corporation was collapsible. We may in this case, therefore, treat the two requirements as one and focus directly upon the objective character of the gain.[14]

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[13] The 70% rule of § 117(m)(3)(B), of course, requires an all-or-nothing treatment, but the statute's target is not less clear for that.

[14] The primary reason for the two separate requirements is that the definition establishes the characterization of the corporation for all purposes, while the 70% rule is separately applied to each year's gains of a stockholder, a difference that could be important in a case involving a series of corporate distributions covering more than one taxable year. However, even where a disposition of the stockholders' entire interest in the corporation occurs, as planned, in a single year, it is at least a theoretical possibility that the sale could have been planned in anticipation of realizing a gain attributable to some

Nor is there any dispute in this case that more than 70% of the $683,500 gain realized by the stockholders was generated by the construction of the buildings, in the sense that it was the excess of the value of the buildings over their cost (and hence over the mortgage indebtedness to which they were subject) that caused their equity in the corporation to be worth $683,500 despite a paid-in capital of only $30. Thus, if it is only that causal relationship that is implied by the phrase, it is undisputed that the petitioners' gain (both as anticipated and realized) was "gain attributable to" the buildings the corporation was availed of to construct.

The sole question in the application of the statute, then, is that raised by petitioners' contention that the function of the "gain attributable to" phrase is not to identify merely the source of the gain—what caused the stock to increase in value—but to make a distinction based on the underlying nature of the gain. As they put it, the question is whether the gain realized is a conversion of what would otherwise have been ordinary income. Actually, as will later appear, the test they would read into the phrase is much more complicated and particularized than that, for they would make determinative of whether there is such a "conversion" what the tax consequences would have been of one particular alternative way (among the

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other expected event but actually produce, failing the event, only a minor gain attributable to the interim production. But whatever the possible difference in other cases, here there is no claim of such a disparity between anticipation and realization and the two requirements become one.

several possible) in which the venture might have been conducted. Specifically, they say that the determinant of § 117(m)'s applicability is how they would have been taxed had they constructed and sold the buildings in their individual capacities without the use of a corporation. If by that means they could have successfully realized their profits from the construction as capital gain, then their gain from the sale of the stock is not, they say, the *kind* of "gain attributable to [the] property" that is contemplated by that phrase.

We need not belabor the textual difficulties in making the words of the statute mean what petitioners would have them mean. Not only does "attributable to" literally refer only to what caused or generated the gain, but the limitation performs an obviously indispensable function given its natural meaning. The gain realized (and anticipated) by stockholders upon the sale of their stock in, say, a manufacturing corporation could be caused by many things other than the values added by manufacturing to the specific manufactured items on hand or in process at the time of sale. The increased value of the stock could reflect, for example, an increase in the value of the corporation's fixed assets (caused, say, by an influx of new industry into the area), an increased demand for its product, or even such an extraneous factor as the discovery of a claim for treble damages for an antitrust violation. The possible causes are infinite, and to confine § 117(m) to its intended scope it was plainly necessary to limit its application to gain that is "attributable to" the specific property the

corporation was availed of to manufacture, construct, or produce. It is only the manufacturing, construction, or production profits that the statute seeks to reach, and the "gain attributable to" phrase, given its literal meaning, is indispensable so to limit it. Nor can petitioners avoid the difficulty by retaining the natural meaning of "attributable to" and making the single word "gain" do the work of supplying an additional limitation. Not only is the word generally used throughout the section, as elsewhere in the Code, to denote merely the excess of proceeds over cost or basis, but it is necessarily in that sense that it is used in the 70% provision in direct association with the "attributable to" limitation.[15]

In fairness to petitioners, we should acknowledge that, apart from a few passing assertions which are never developed, they do not really pretend that the language of the statute can conveniently, or even with considerable straining, be made to hold the meaning that they would give it. Ultimately, their argument, though perhaps less candidly stated, is the same as that adopted by the Fifth Circuit in the conflicting decision on which they rely, *United States* v. *Ivey*, 294 F. 2d 799, rehearing denied with opinion, 303 F. 2d 109—namely, that, while there is no language in the statute to suggest it, an implied exception should be read into the statute to prevent allegedly absurd results and to give effect to Congress' under-

[15] That provision exempts a stockholder's total "gain" (necessarily, proceeds less basis) if less than 70% of "such gain" is "attributable to" the constructed property.

lying purpose. As the flavor of their brief as a whole makes evident, petitioners offer the "gain attributable to" phrase simply as the most convenient point at which to read into the statute—or as the most convenient "hook" on which to hang—an implied limitation which they contend must be made to make "sense" out of the statute.[16]

We will in the next Point meet petitioners on their own terms and demonstrate that not only does the statute as written fully carry out its basic purpose—which we agree is to prevent a conversion of ordinary income into capital gain—but that this case presents a classic example of the very kind of ordinary-income "conversion" at which the statute was aimed. Before so demonstrating, however, we will show that the petitioners' plea for a judicial, rather than legislative, rescue would have to be denied even if it were true that the statute as written produces results seemingly at odds with Congress' apparent purpose.

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[16] By pin-pointing the "gain attributable to" phrase as the situs of their implied limitation, petitioners offer a considerable improvement, we must acknowledge, over the Fifth Circuit's creation of an exception at large. Under the *Ivey* approach, the mechanics of the statute are abandoned entirely, with the court simply looking through the corporate form and making its own apportionment of the gain into that taxable as ordinary income and that taxable as capital gain. Petitioners, though not acknowledging their departure from the Fifth Circuit, understandably eschew such a total destruction of the statutory scheme. By choosing the "gain attributable to" phrase as the place in the statutory structure at which to locate the implied limitation, they at least preserve much of the mechanical operation of the statute, in particular the all-or-nothing operation of the 70% limitation (see Br. 76-78).

We of course agree with the general propositions proved by petitioners at such remarkable length: that statutory language should be read—indeed, even strained to some degree—to avoid absurd results, to carry out the discovered purposes of Congress, and in general, in an effort to produce a rational, sensible structure. Yet it must equally be acknowledged that there are limits to "interpretation." And what petitioners ask is not "interpretation" nor even "substitution"; it is the addition, out of whole cloth, of a highly specific and complex set of standards by which to determine the application of the statute.

It is true, as petitioners point out, that there are some words in the Code, found primarily in the broad provisions creating the basic framework of the tax system—such as "income" (§ 22(a)), "ordinary and necessary" (§ 23(a)), "gift" (§ 22(b)(3)), or "property" (§ 117(a))—that perforce can be given meaning only through judicial exegesis bringing to bear rather general notions of underlying statutory policy and the needs of a rational and workable tax structure. But as Judge Learned Hand observed, "as the articulation of a statute increases, the room for interpretation must contract." *Helvering* v. *Gregory*, 69 F. 2d 809, 810 (C.A. 2), affirmed, 293 U.S. 465. And in a statute articulated in such great detail as § 117(m), with its elaborate definitions and enumeration of explicit exceptions and limitations, there is no room for the kind of extensive rewriting that petitioners seek.

Nor does the statute arrive here newborn. It was enacted in 1950, and an intricate and complicated set of regulations interpreting it has been in force since 1953. Petitioners make no claim that their reading can be reconciled with the regulations, and of course it cannot.[17] Even were the statute ambiguous, as it is not, the regulations would control. *E.g.*, *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501; *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90, 103. The statute has, moreover, been extensively litigated, with the great bulk of the cases[18] involving corporations formed, like Springfield, to construct apartment-house projects financed with FHA-insured loans. Yet not until 1961, when the Fifth Circuit's decision in *Ivey* was announced, was it ever suggested that the statute

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[17] See, *e.g.*, Treas. Regs. 111, § 29.117-11(c)(3), which defines "gain attributable to the property" as simply "the excess of the recognized gain of the shareholder during the taxable year * * * over the recognized gain which the shareholder would have if the property had not been manufactured, constructed [or] produced." See also § 29.117-11(e), Example (1), giving as an example of a collapsible corporation the very kind of FHA-financed construction project involved here. Those provisions were first added to Regulations 111 by T.D. 5999, 1953-1 Cum. Bull. 187.

Treas. Regs. 118 (1939 Code), § 39.117(m)-1 (c)(3)(ii) and (e) (Ex. 1), and Regs. (1954 Code), §§ 1.341-4(c)(2), 1.341-5(d) (Ex. 1), are substantially the same.

[18] See, *e.g.*, *Glickman* v. *Commissioner*, 256 F. 2d 108 (C.A. 2); *Hartman* v. *Commissioner*, 296 F. 2d 726 (C.A. 2); *Mintz* v. *Commissioner*, 284 F. 2d 554 (C.A. 2); *Abbott* v. *Commissioner*, 258 F. 2d 537 (C.A. 3); *August* v. *Commissioner*, 267 F. 2d 829 (C.A. 3); *Burge* v. *Commissioner*, 253 F. 2d 765 (C.A. 4); *Spangler* v. *Commissioner* 278 F. 2d 665 (C.A. 4), certiorari denied, 364 U.S. 825; *Pomponio* v. *Commissioner*, 288 F. 2d 827 (C.A. 4); *Payne* v. *Commissioner*, 268 F. 2d 617 (C.A. 5); *Jacobson* v. *Commissioner*, 281 F. 2d 703 (C.A. 3).

was susceptible to an interpretation avoiding its application to such transactions.[19] The commentators, too, shared the universal assumption of the courts and litigants that the statute did not permit of interpretive relief even if it should operate, in a given case, to reach what would otherwise have been capital gain.[20] Thus, it is not only the words of the statute, but also the regulations and the established understanding of the courts and the tax bar, that petitioners must overcome.

If the obstacles are not already enough, there remains the fact that the collapsible-corporation provi-

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[19] Perhaps credit for the suggestion should go to the 1960 district court decision in *Honaker Drilling, Inc.* v. *Koehler*, 190 F. Supp. 287 (D. Kan.).

[20] Mertens, Federal Income Taxation, Code Commentary, § 341(b)(3):1; 3B Mertens, Federal Income Taxation, § 22.64 p. 271; DeWind and Anthoine, *Collapsible Corporations*, 56 Col. L. Rev. 475, 487, 508–509; Bittker, Federal Income Taxation of Corporations and Shareholders, pp. 309–310 (1959); Anthoine, *Federal Tax Legislation of 1958*, 58 Col. L. Rev. 1146, 1175, 1178 (1958); Axelrad, *Collapsible Corporations and Partnerships*, 1960 U. of So. Calif. Tax Inst. 269, 295; Seidman, *"Collapsible" Corporations—Applicable to Real Estate Transactions*, 15 Tax. L. Rev. 121, 132–135 (1959); Modrall, *Collapsible Corporations and Subsection (e)*, 37 Taxes 895, 897 (1959); Axelrad, *Recent Developments in Collapsible Corporations*, 36 Taxes 893, 916 (1958).

Comment after the *Irey* decision has been uniformly critical of the decision. Turner, *Judicial Trend Is Limiting Restrictions On Collapsible Corporations*, The Journal of Taxation (June, 1962), pp. 322, 327; Hewitt and Randerson, *Shareholder's Capital Gains Status No. § 341 Defense: CA-2 Conflicts With Irey*, The Journal of Taxation, pp. 194–195 (October, 1962); Ruecker, *Collapsible Dangers Can Be Avoided Despite Uncertainties; Cert Granted In Braunstein*, The Journal of Taxation, pp. 77, 80 (February, 1963).

sions have been the subject of continuous legislative study and revision since their adoption.[21] And in the 1958 amendments, Congress finally responded to claims, like petitioners', that the provision ought not apply to certain circumstances in which the gain might, by some other means, have been realized as capital gain. It did so by adding (as § 341(e) of the 1954 Code) an extremely complicated provision carving out four limited exceptions to the application of the statute. While we agree with petitioners that subsequent legislative developments provide little aid in interpreting an earlier statute,[22] the fact that Congress has "taken hold" of an alleged defect in the statute and provided relief much more circumscribed than that sought from the Court is surely relevant when what the Court is asked to do amounts, as here,

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[21] In 1951, the definition of a collapsible corporation was broadened to include corporations formed or availed of to purchase inventory assets. Revenue Act of 1951, § 326, 65 Stat. 452. Section 117(m) was substantially re-enacted as § 341 of the 1954 Code, but with an expansion to other categories of purchased property and to shareholders owning more than 5% of the stock. In addition, a presumption was provided as to when a corporation might be deemed collapsible. The Technical Amendments Act of 1958, § 20(a), 72 Stat. 1606, added § 341(e) to the Code, providing limited exceptions to the collapsible-corporation provisions in four situations. The latest amendment, in 1962, provided that the determinations required by § 341(e) should be made without regard to the application of § 1245(a), which provides rules for determining gain on the sale of depreciable property. Act of October 16, 1962, § 13(f)(4), 76 Stat. 960, adding § 341(e)(12).

[22] See *United States* v. *Price*, 361 U.S. 304, 313; but cf. *Great Northern Ry. Co.* v. *United States*, 315 U.S. 262, 267; *Brewster* v. *Gage*, 280 U.S. 327, 337. See also *American Automobile Ass'n.* v. *United States*, 367 U.S. 687, 694–698.

not to "interpretation" but to judicial "correction" of an alleged statutory oversight. And if nothing else, the complexity of the 1958 amendments reveals the immense difficulties inevitably encountered in implementing a "what might have been" standard of liability of the sort petitioners ask this Court to create and define quite without statutory aid.

II

THE TRANSACTION IN THIS CASE INVOLVES AN ATTEMPTED CONVERSION INTO CAPITAL GAIN OF VALUES CREATED BY THE PETITIONERS' PERSONAL EFFORTS, THE VERY ABUSE AT WHICH THE COLLAPSIBLE-CORPORATION PROVISIONS WERE AIMED

We fully agree with the proposition petitioners prove at such great length: that the basic purpose of the statute is to prevent the conversion of ordinary income into capital gain. We disagree only with what they assume: that it is necessary to rewrite the statute to conform it to that purpose and that the transaction in this case does not involve such an attempted conversion of ordinary income. We will show, contrary to petitioners' assumptions, (A) that the statute is by its own terms confined to transactions reasonably deemed by Congress to involve ordinary income conversions and (B) that the transaction in this case is a flagrant example of the abuse at which the statute was aimed. We will then show (C) that the sense in which petitioners speak of ordinary-income "conversions" in describing the purpose of the statute (by a reference to the tax consequences of one specific alternative way of con-

ducting the venture) is a highly artificial one plainly not attributable to Congress.

A. THE STATUTE'S TERMS CONFINE ITS APPLICATION TO GAINS REPRESENTING NORMAL CONSTRUCTION OR MANUFACTURING PROFITS

The statute applies, by its terms, only to corporations used for the "manufacture, construction, or production of property" and only to attempts by stockholders to realize as proceeds from stock the gain "attributable to the property so manufactured, constructed, or produced." Manufacturing, construction, and production are all endeavors by which capital and labor are employed to *create* values, and the realization upon the values so created (the only thing the statute taxes) is but the normal return for the labor and capital employed. It is a gain of a fundamentally different character from the kind of long-term appreciation in value, due to changes in market conditions, that is at least the polar example of gains for which special capital-gains taxation has traditionally been thought justified. See, *e.g.*, *Commissioner* v. *Gillette Motor Transport*, 364 U.S. 130, 134. In § 117(m), Congress has simply made the judgment that such construction and manufacturing profits are in their "nature" ordinary income, and ought to be taxed as such rather than be allowed to be "converted" into capital gain through stock sales. That eminently sensible policy judgment provides a complete explanation both of the purpose and of the language of the statute. To confine the statute to its purpose of preventing the "conversion" of ordinary income into capital gain, the Court need only apply it as written.

B. THE GAIN REALIZED BY PETITIONERS WAS A REALIZATION, IN CONVERTED FORM, OF COMPENSATION FOR THEIR PERSONAL SERVICES

That petitioners, despite repeated assertions about the nature of their gain, never in fact examine its nature—or even allude to the facts of the transaction [23]—is perhaps understandable. For it requires only a statement of the transaction to make painfully apparent that the petitioners' gains—obliquely described by them as "resulting from a conversion of capital investment" or an "appreciation in value accrued over a substantial period of time" (Br. 23)—were but the normal profits from construction activities, a realization upon values which they themselves had created by their contributed services.

A fair arm's-length price for the construction services performed by petitioners for the corporation, as estimated by the petitioners themselves and the FHA, was $4,514,705. Petitioners, eliminating the architect's fee, the builder's fee, and the subcontractors' normal markup,[24] in fact did the work for their out-of-pocket cost of $3,807,908, a "discount" of $706,797. Had the petitioners actually charged the estimated fair price (as the "paper" contracts purported to), they would have ended up with construction profits of $706,797, taxable to them as ordinary income. By

[23] Their statement of facts is limited to a recital of the evidence which they contended below showed that they had not, during construction, contemplated "selling out," the question which, by limiting the writ, this Court declined to review.

[24] To the extent that there were also "real" savings over the estimated costs—as distinguished from the elimination of various profit elements—those too would normally go to enhance the contractor's profits rather than be passed on to the owner.

charging only the out-of-pocket costs and contributing the use of their own services and their construction organization and know-how, they were able instead to convert the "savings" into an increase in the value of their equity—*i.e.*, by creating for the corporation buildings presumably "worth" (on the FHA estimates) over $700,000 more than they cost (and, hence, more than the mortgage indebtedness to which they were subject). Then to realize their construction profits in the form of a gain from the sale of stock, they had only to find a buyer who considered the buildings to be worth their estimated fair cost, as of course they did. The $683,500 that the petitioners realized upon the disposition of their stock, far from resulting from a "conversion of capital investments" (to wit, the $30 they contributed for the stock), resulted plainly and simply from the "conversion" of the value of their contributed construction services. In a word, they took out of the corporation in the form of proceeds from the sale of stock neither more nor less than what they put into it in the form of contributed services. The receipts they claim as capital gain are but a conversion of what ought to have been (and, in an arm's-length transaction, would have been) taxed as compensation for services.

This case, then, far from involving an "unintended" application of the terms of § 117(m), is an extreme and flagrant example of the very abuse at which the statute was directed: the conversion into capital gain of the normal profits generated by the manufacture, construction, or production of property. Petitioners

are able to describe it otherwise only by a careful failure to describe it at all.

C. THAT PETITIONERS MIGHT HAVE BEEN ABLE TO CONVERT THE VALUE OF THEIR SERVICES INTO CAPITAL GAIN BY ANOTHER MEANS IS IRRELEVANT

Instead of an analysis of the transaction and of the underlying source and nature of the gain, petitioners offer as the sole determinant of whether there has been a "conversion" of ordinary income into capital gain (for purposes presumably of ascertaining the congressional purpose) a reference to what the tax consequences would have been of one particular alternative way in which the venture might have been conducted. Of the several possible transactions that would produce substantially the same economic consequences, petitioners choose as their "model"—upon the tax consequences of which the Court is asked to make the application of § 117(m) depend—one that involves a particularly great restructuring of the transaction: namely, the construction and sale of the buildings by the petitioners in their individual capacities without the use of a corporation.[25] They then assert (with no support other than cross-references to the same assertion elsewhere in their brief) that, had they conducted the venture in that form, their gain would have been taxed only as capital gain. Since the tax consequences of that chosen model must, for some unexplained reason, be taken as establishing the

[25] In fact, petitioners stated in the court of appeals (Reply Br. 4) that the FHA required the use of a corporation for any mortgage in excess of $200,000. If so, they could not in fact have conducted the enterprise as individuals.

"true" nature of the gain, it follows that the government is attempting to pervert the statute by applying it "so as to produce a conversion of capital gain into ordinary income" (Br. 95).[26]

There are two basic fallacies in the unstated premises of petitioners' argument. The first unsupportable premise is that, in adopting § 117(m), Congress chose not to make its own policy judgment of the kinds of gain that "ought" to be taxed as ordinary income and not be allowed to be "converted" into capital gains by stock sales, but rather decided to make the statute's application dependent upon a judicial determination in each case of how the transaction would have been taxed had it been conducted in some other way. Not only is that an unusual way for Congress to act, but the detailed prescription in § 117(m) of the transactions to which it is to apply makes the premise specious on its face.

Second, even assuming Congress meant to leave the operation of its statute dependent in each case upon a judicial characterization of the underlying gain, what possible reason is there why the characterization should be determined solely by the tax conse uences of the particular hypothetical alternative transaction that the taxpayers choose to offer as a model? The model petitioners offer (construction and sale as in-

[26] The government's action, indeed, is not merely erroneous; it "violates the standards of responsible tax administration" and raises fundamental questions going "to the very essence of tax administration in our democratic society" and casting in doubt "no less than the integrity of the administrative process in our tax system." Pet. Br., Pt. VI, pp. 94–102.

dividuals) is not the only alternative way of achieving the same economic results nor even the closest one (in the sense of involving the least restructuring). The closest model is the one petitioners themselves set up "on paper"—to wit, the payment by the corporation to them of a full arm's-length price for their construction services. That, indeed, involves no basic restructuring at all, but simply the elimination of the non-arm's-length element from the dealings between the corporation and the partnership controlled by the same persons. And, of course, if an arm's-length version of the actual transaction were to be chosen as the model, it would reveal the obvious truth that the gain petitioners realized was in fact nothing more than an indirect realization of the value of their construction services.

In the end, petitioners' entire argument reduces itself to a play upon words, the key to which is the very specialized meaning they insinuate into the phrase "conversion of ordinary income into capital gain." Such catchwords are capable of being given many meanings, but surely the usual meaning, at least in the context of discussions of basic statutory policy, is quite different from petitioners' usage. The phrase rather presupposes the existence of a rational policy distinction between the elements of economic gain that should be (and generally are) taxed as ordinary income and those that should be (and generally are) taxed as capital gain. If that which should be taxed as ordinary income under the basic rationale is realized in such a way ~~that if~~ in fact obtains capital-gains treatment, the departure from the norm is de-

scribed as a "conversion of ordinary income into capital gain." To a large extent, the reference is to the "ought" and, to the extent that it is to the "is", it is to the way in which the basic elements of the gain are *generally* treated for tax purposes, not to the outcome of a single, particularized, hypothetical transaction. The return from the performance of personal services, for example, is *generally* taxed as ordinary income; and if in some cases values which a taxpayer has created by his personal efforts are allowed to be taxed as capital gain, the result is commonly, and fairly, described as a "conversion of ordinary income into capital gain." And that is an equally valid description whether or not there is more than one way in which the "conversion" might be accomplished.

Thus the fact, if true (but see notes 27–28, *infra*), that the petitioners could have converted their construction profits into capital gain by conducting the venture as individuals proves nothing. It means only that there still exist other means by which the fruits of one's personal labor, generally taxed as ordinary income, may be "converted" into capital gain. In the case of individuals creating property for use by themselves, there may of course be sufficient reasons of policy, or of practicality, for tolerating the element of ordinary-income "conversion" involved,[27] but that plainly affords no reason why

[27] The main obstacle seems to be the problem of "realization" combined with the difficulty of apportioning a single gain into its several elements. If an individual devotes his labor to build a house, he has created values from his personal services which in principle should be taxed as ordinary income. If he does not immediately sell the house, however, there is at that

Congress should tolerate the use of corporations with a specific view to exploiting such "conversion" possibilities. Whatever the result in the hypotheti-

point no "realization" of the values. And when later he does sell the house, there is no easy way to distinguish between the proceeds representing a realization upon the values originally created by his efforts and those attributable to long-term appreciation during the period of his holding. The admittedly imperfect, but practical, solution that has been adopted is to treat the gain all or none as capital gain depending generally upon the taxpayers' purpose in creating and holding the property. To use only polar examples, the property is treated as a capital asset if it was created and held solely for self-use or rental purposes without thought of sale but not if it was created and held solely for the purpose of sale. The precise dividing line is, of course, a difficult question and one on which the law is in a state of flux. See, in particular, *Rollingwood Corp.* v. *Commissioner*, 190 F. 2d 263, 266 (C.A. 9); *Pacific Homes, Inc.*, v. *United States*, 129 F. Supp. 796 (N.D. Cal.), affirmed, 230 F 2d 755 (C.A. 9).

It is interesting to speculate whether the above cases are not the beginnings of a judicial recognition that taxpayer-created properties pose problems quite different from those of purchased properties and the development for the former of standards closely similar to those of § 117(m)—*i.e.*, created property is not a capital asset if sale was contemplated during construction as one of the substantial possible alternatives and the property was in fact sold quite soon after construction. Although the general definitions of a "capital asset" (§ 117(a)(1)) (or of what amounts to the same thing for present purposes, "property used in the trade or business", § 117(j)) do not allude to the difference between purchased and created properties, those definitions are admittedly so general that the articulation of the precise dividing lines has necessarily been left to the courts. See, *e.g.*, *Commissioner* v. *Gillette Motor Transport*, 364 U.S. 130; *Commissioner* v. *Lake*, 356 U.S. 260. And in the case of certain types of created properties where the "conversion" of ordinary income is particularly extreme—copyrights, books, musical or artistic compositions and the like, properties which are almost entirely the product of personal

cal case petitioners offer as a model,[28] the fact remains that the gain they realized upon the sale of the stock was attributable entirely to values created by the construction services they contributed to the corporation. And the use of a corporation to effect such a conversion of the value of personal services (or, more generally, values created in the construction process) into the proceeds of a stock sale was the very

efforts and requiring little, if any, capital investment—Congress has taken the extreme step of denying capital-gains treatment to the creator regardless of how long or for what purpose he holds the property. See § 117(a)(1)(C); H. Rep. No. 2319, 81st Cong., 2d Sess., pp. 54, 92-93; S. Rep. 2375, 81st Cong., 2d Sess., pp. 43-44, 83-84. That that provision was added at the same time as § 117(m) confirms the primary concern of Congress with the conversion of "created" values into capital gain.

[28] The question is a difficult one, not only because the law applicable to construction and sale by individuals is unclear and in a state of evolution (see note 27, *supra*), but because it is unclear exactly what assumptions are to be made in stating petitioners' hypothetical question. What precisely, for example, is to be assumed about the state of mind they would have had had they acted as individuals? The transfer of attitudes necessarily formed with respect to the existence and use of the corporate form to an assumed transaction in which there is no corporation is no small feat. For another example of the difficulties, what is to be assumed about the petitioners' other construction ventures conducted through other corporations: if Springfield is to be assumed away, are the other corporate entities likewise to be ignored? For the complex treatment of the latter problem found necessary by Congress when it undertook to give relief of the nature petitioners seek, see § 341(e) of the 1954 Code. Because of all those difficulties, we have made no effort here to answer petitioners' hypothetical question. Should it prove to be relevant, it would be necessary in any event to remand the case to the Tax Court for it to determine the question in the first instance.

kind of "conversion of ordinary income into capital gain" at which the statute was specifically directed.[29]

III

THE LEGISLATIVE HISTORY SHOWS THAT THE PRIMARY OBJECT OF THE STATUTE WAS A TRANSACTION IDENTICAL IN ALL ESSENTIAL ELEMENTS TO THE TRANSACTION IN THIS CASE

The enactment of § 117(m) was prompted by a specific tax abuse prevalent in the making of motion pictures. The offending transaction was described in detail in the committee reports[30] but its essence

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[29] We may note, finally, that even if petitioners are right about the tax treatment they would have received as individuals, this would not be the first time that persons using the corporate form have had to accept the tax consequences of their choice. See, *e.g.*, *Moline Properties* v. *Commissioner*, 319 U.S. 436.

[30] H. Rep. No. 2319, 81st Cong., 2d Sess., pp. 56–57; S. Rep. No. 2375, 81st Cong., 2d Sess., p. 45:

"The collapsible corporation is a device which has been used in an attempt to convert ordinary income into long-term capital gain by use of a temporary corporation. The device has been used principally in the motion-picture industry. A legitimate corporation engaged in the business of producing motion pictures would pay ordinarily the corporate income tax on its net income and its shareholders would pay ordinary income tax on their dividends from the corporation. Producers have tried to avoid these results by organizing separate corporations for each motion picture. Upon completion of the film but prior to the realization by the corporation of any income therefrom, the corporation is liquidated and the assets are distributed. In such a case, the corporation pays no tax, claiming that it has realized no income. The producer pays tax upon the difference between his cost and the fair market value of the assets so distributed; but such gain is reported as long-term capital gain with a maximum effective rate of 25 percent. After liquidation, the fair

was given in President Truman's recommendation to Congress (Hearings before House Committee on Ways and Means on Revenue Revision of 1950, 81st Cong., 2d Sess., p. 5):

> * * * As one example, under present law producers of motion pictures, and their star players, have attempted to avoid taxes by creating temporary corporations which are dissolved after making one film. By this device, their income from making the film, which ought to be taxed at the individual-income tax rates, would be taxed only at the capital-gains rate. * * *

Our purpose is to demonstrate that the apartment-building transaction in this case is an identical twin to the movie-making transaction that prompted the statute.

In the proscribed movie-making transaction, a producer and actors form a corporation, contribute their services to it for the making of a movie, and liquidate the corporation when the movie is finished. Upon liquidation, they are taxed on the value of the movie as capital gain. That taxed value then becomes their basis in the movie which they may recover tax-free from the proceeds of leasing or selling it. Alternatively, the stockholders could simply sell the stock

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market value of the released production is ordinarily amortized against the income from the film as it is received. If the income from the film does not exceed such fair market value, there is no further tax.

"In addition to the motion-picture industry, it is understood that the collapsible-corporation device has also been used in the building-construction trade by contractors who have corporations construct buildings for sale and then liquidate the corporations and sell the buildings as individuals."

after the movie was completed,[31] leaving it to the buyer to liquidate and transfer his cost basis to the movie. Either way, the difference between the cost of the movie and its value on completion is taxed solely as capital gain.

The basic abuse of that transaction is the conversion of the values created in producing the movie, through the stockholders' contributed services, into capital gain. Had the corporation been allowed to exploit the movie, those values would ultimately have been realized as ordinary rental income, since the corporation could offset (amortize) only the actual costs against the rental income. The prompt "collapsing" of the corporation prevents that ordinary-income realization of the created values and "converts" them into capital gain.

Moving from that aboriginal example of the "collapsible corporation" to this case, it is evident that only the locale and the cast of characters have been changed. Apartment buildings have been substituted for movies and architects and builders for producers and actors, but the scenario is otherwise the same. The values are created in the same way (by the contributed services of the stockholders) and realized in the same way (by liquidation or sale of the stock). In neither case is compensation paid for the services and in neither case is the corporation allowed to realize the created values by converting them into ordinary rental income. In both cases, if the stockholders liqui-

[31] The statute plainly makes nothing turn on whether the corporation is liquidated or the stock sold. See § 117(m)(1), (2)(A)(i); see also H. Rep. No. 2319, *supra*, p. 97.

date the corporation they will receive (in exchange for only a capital gains tax) a new basis to amortize or depreciate against the rental receipts; and if they sell the stock the buyer can transfer his basis to the assets by a subsequent liquidation. In short, to the last significant detail, the transactions are identical.[32]

To conclude the matter, it needs to be added only that, prior to the 1950 act, individuals making a movie purportedly for rental purposes and then selling it could have made precisely the same claim to capital-gains treatment that petitioners make for their hypothetical transaction (*i.e.*, individuals construct-

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[32] Petitioners, to avoid the impact of the movie example, draw a distinction between liquidations and stock sales, arguing in effect that movie-making corporations can still be "collapsed" with capital-gains treatment, notwithstanding § 117(m), if only the actors and producers, upon completion of the movie, take care to sell their stock rather than liquidate the corporation (Br. 69–76). For all the acclaim with which it would be received in Hollywood, the distinction is as lacking in economic reality as it is in statutory support (see note 31, *supra*). If a corporation has created a movie worth $1,000,000, the stockholders can realize its value either by selling their stock for $1,000,000 or by distributing the movie to themselves in liquidation (thereafter either selling it for $1,000,000 or recovering its $1,000,000 value out of rental proceeds). The gain realized by the two routes, far from being "distinctly unlike" (Pet. Br. 71), is identical in source and nature: in either case it is the direct realization by the stockholders of the values created by the movie's production. And even the surface distinction between liquidations and stock sales evaporates when it is recognized that the purchaser of the stock (in stock sales) is free immediately to liquidate the corporation, while the stockholders receiving the property (in liquidations) are free immediately to sell it. The two routes thus not only produce the same gain for the stockholders but may produce identical end results even for the purchaser.

ing a building purportedly for rental purposes and then selling it). Thus, even assuming petitioners to be right on the merits of that claim, it is evident that Congress did not take the tax treatment of individuals in a particular alternative transaction as the determinant either of the application of its new statute or of what it meant by the criticized "conversion" of ordinary income.[33] To put the matter most bluntly, for petitioners to prevail the Court would have to hold no less than that § 117(m) did not by its terms apply to the case that prompted its enactment.

CONCLUSION

We have emphasized the facts of this case—in particular, the origin of petitioners' gains in their contribution of services—only because of petitioners' insistence that, despite the literal applicability of the statutory language, the case does not involve the kind of transaction to which Congress "intended" § 117 (m) to apply. Quite to the contrary, we have shown, the actual facts present in exaggerated form the most

[33] Although the committee reports on § 117(m) do not allude to the fact, we note that another provision of the same act (§ 210(a), Revenue Act of 1950, 64 Stat. 932) amended the definition of a capital asset to exclude "a copyright; a literary, musical, or artistic composition; or similar property; held by * * * a taxpayer whose personal efforts created such property" (§ 117(a)(1)(C)). At least in some situations, that provision might well apply to a motion-picture made by an individual, and to that extent remove the parallelism after 1950 between individual apartment-building and individual movie-making. Nothing in the history, however, suggests that Congress' purpose in § 117(m) to proscribe the corporate abuse typified by the movie example was derived from or dependent upon the amendments to the "capital asset" definition.

blatant kind of abuse at which the statute was aimed: the conversion, as in the movie example, of contributed personal services into the proceeds of stock. In closing, however, it is important to reemphasize what is of the essence and what is not. By its terms, the statute is concerned generally with the conversion of values generated by the "manufacture, construction, or production of property," and the specific identity of the factors primarily responsible for the values created in those processes (capital, labor, know-how, sound market analysis, or whatever) is ultimately immaterial. The stockholders' contribution of services to the process may dramatically increase the resulting excess of value over cost and thereby highlight the abuse, but the statute reaches all gains "attributable to the property so manufactured, constructed, or produced" regardless of whether they represent only the normal profits of manufacturing and construction (the values added simply by combining the necessary factors of production to create an economically useful product) or, as here, profits artificially inflated by the contribution of services.

The surest guide to the intended scope of the statute is its own terms, and what should be ultimately controlling here, therefore, is not the fact, though true and revealing the extent of the abuse, that the gains can be traced back to the contributed personal services of the petitioners. What should control, quite simply, is that the corporation was used "for the manufacture, construction, or production of property" (§ 117(m)(2)(A)) and the gain sought and realized by the contemplated stock sale was "gain

* * * attributable to the property so manufactured, constructed, or produced" (§ 117(m) (3)(B), (2)(A)(ii)). By limiting the gain it taxes as ordinary income to that representing values added in the income-producing processes of "manufacture, construction, or production,"[34] the statute executes in precise degree its purpose to prevent the "conversion of ordinary income into capital gain." To confine it to that purpose, no judicial exegesis is needed.

For the reasons stated, the judgment of the court of appeals should be affirmed.

Respectfully submitted.

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MARCH 1963.

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[34] See H. Rep. No. 2319, *supra*, p. 98, and S. Rep. No. 2375, *supra*, p. 90, explaining why the statute was drawn to include a corporation which engaged in the manufacture, construction, or production of property "to any extent" (§ 117(m) (2) (B) (i)) even though it neither began nor completed the process: "It will nonetheless be deemed to have manufactured, constructed or produced property in that its shareholders may realize gain with respect to the additional value added to the property by the manufacture, construction or production to the extent that it was carried out."

APPENDIX

INTERNAL REVENUE CODE OF 1939

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

(m) [As added by Revenue Act of 1950, § 212(a), 64 Stat. 906] *Collapsible Corporations.*—

(1) *Treatment of gain to shareholders.*—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) *Definitions.*—

(A) For the purposes of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

(i) The sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

(ii) the realization by such shareholders of gain attributable to such property.

(B) For the purposes of subparagraph (A), a corporation shall be deemed to have manufactured, constructed, or produced property, if—

(i) it engaged in the manufacture, construction, or production of such property to any extent,

(ii) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, or produced the property, or

(iii) it holds property having a basis determined in whole or in part, by reference to the cost of property manufactured, constructed, or produced by the corporation.

(3) *Limitations on application of subsection.*—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is at-

tributable to the property so manufactured, constructed, or produced; and

(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production.

For purposes of subparagraph (A), the ownership of stock shall be determined in accordance with the rules prescribed by paragraphs (1), (2), (3), (5), and (6) of section 503(a), except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants.

TREASURY REGULATIONS 111 (1939 CODE)

SEC. 29.117-11 [as added by T.D. 5999, 1953-1 Cum. Bull. 187]. *Collapsible Corporations.*—(*a*) *In general.*—With respect to taxable years ending after December 31, 1949, but only with respect to gain realized after such date, and subject to the limitations contained in (*c*) hereof, the entire gain from (1) the actual sale or exchange of stock of a collapsible corporation, (2) amounts distributed in complete or partial liquidation of a collapsible corporation which are treated, under section 115(c), as payment in exchange for stock, and (3) a distribution made by a collapsible corporation which, under section 115(d), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property, shall be considered as gain from the sale or exchange of property which is not a capital asset.

(*b*) *Determination of collapsible corporation.*—With respect to taxable years ending after December

31, 1949, but only with respect to gain realized after such date, a collapsible corporation is defined by section 117(m)(2)(A) to be a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to (1) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and (2) the realization by such shareholders of gain attributable to such property. * * *

* * * * *

Under section 117(m)(2)(A), the corporation must be formed or availed of with a view to the action therein described, that is, the sale or exchange of its stock by its shareholders, or a distribution to them, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property, and the realization by the shareholders of gain attributable to such property. This requirement is satisfied in any case in which such action was contemplated by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise. The requirement is satisfied whether such action was contemplated unconditionally, conditionally, or as a recognized possibility. * * *

A corporation is formed or availed of with a view to the action described in section 117(m)(2)(A) if the requisite view existed at any time during the

manufacture, production, construction, or purchase referred to in that section. * * *

The property referred to in Section 117(m)(2)(A) is that property or the aggregate of those properties with respect to which the requisite view existed. In order to ascertain the property or properties as to which the requisite view existed, reference shall be made to each property as to which, at the time of the sale, exchange, or distribution referred to in section 117(m)(2)(A), there has not been a realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property. * * *

* * * * *

(c) *Limitations on application of section.*—* * * (3) *Seventy-percent rule.*—This section shall apply to the gain recognized during a taxable year upon the stock in a collapsible corporation only if more than 70 percent of such gain is attributable to the property referred to in section 117(m)(2)(A). If more than 70 percent of such gain is so attributable, then all of such gain is subject to this section, and, if 70 percent or less of such gain is so attributable, then none of such gain is subject to this section.

For the purpose of this limitation, the gain attributable to the property referred to in section 117(m)(2)(A) is the excess of the recognized gain of the shareholder during the taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased. In the case of gain on a distribution in partial liquidation or a distribution described in section 115(d), the gain attributable to the property shall not be less than an amount

which bears the same ratio to the gain on such distribution as the gain which would be attributable to the property if there had been a complete liquidation at the time of such distribution bears to the total gain which would have resulted from such complete liquidation.

Gain may be attributable to the property referred to in section 117(m)(2)(A) even though such gain is represented by an appreciation in the value of property other than that manufactured, constructed, produced, or purchased. Where, for example, a corporation owns a tract of land and the development of one-half of the tract increases the value of the other half, the gain attributable to the developed half of the tract includes the increase in the value of the other half.

(4) *Three-year rule.*—This section shall not apply to that portion of the gain of a shareholder that is realized more than 3 years after the actual completion of the manufacture, construction, production, or purchase of the property to which such portion is attributable.

(d) *Application of section.*—(1) Whether or not a corporation is a collapsible corporation shall be determined under the rules of (*b*) of this section on the basis of all the facts and circumstances in each particular case. The following paragraphs set forth those facts which will ordinarily be considered sufficient to establish that a corporation is or is not a collapsible corporation. The facts set forth in the following paragraphs are not exclusive of other facts which may be controlling in any particular case. * * *

*   *   *   *   *

(2) The following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (1), above, and paragraph (3), below)

to establish that a corporation is a collapsible corporation:

(i) A shareholder of the corporation sells or exchanges his stock, or receives a liquidating distribution, or a distribution described in section 115(d),

(ii) Upon such sale, exchange or distribution, such shareholder realizes gain attributable to the property described below, and

(iii) At the time of the manufacture, construction, production, or purchase of the property described below, such activity as substantial in relation to the other activities of the corporation which manufactured, constructed, produced, or purchased such property.

The property referred to above is that property or the aggregate of those properties which meet the following two requirements:

(iv) The property is manufactured, constructed, or produced by the corporation * * *, and

(v) At the time of the sale, exchange, or distribution described in (i) above, the corporation which manufactured, constructed, produced, or purchased such property has not realized a substantial part of the net income to be derived from such property.

In the case of property which is a unit of an integrated project involving several properties similar in kind, the rules of this paragraph shall be applied to the aggregate of the properties constituting the single project rather than separately to such unit. * * *

* * * * *

(e) *Examples.*—The following examples will illustrate the application of this section:

Example (1). On January 2, 1951, A formed the W Corporation and contributed $50,000 cash in exchange for all of the stock thereof. The W Corporation borrowed $900,000 from a bank, the loan being insured by the Federal Housing Authority, and used $800,000 of such sum in the construction of an apartment house on land which it purchased for $50,000. The apartment house was completed on December 31, 1951. On December 31, 1951, the corporation, having determined that the fair market value of the apartment house, separate and apart from the land, was $900,000, made a distribution (permitted under the applicable state law) to A of $100,000. At this time, the fair market value of the land was $50,000. As of December 31, 1951, the corporation has not realized any earnings and profits. In 1952, the corporation began the operation of the apartment house and received rentals therefrom. The corporation has since continued to own and operate the building. The corporation reported on the basis of the calendar year and cash receipts and disbursements.

Since A received a distribution and realized a gain attributable to the building constructed by the corporation, since, at the time of such distribution, the corporation has not realized a substantial part of the net income to be derived from such building, and since the construction of the building was a substantial activity of the corporation, the W Corporation is considered a collapsible corporation under (*d*)(2) of this section. The provisions of section 117(m)(3) do not prohibit the application of section 117(m)(1) to A. Therefore, the distribution, if and to the extent that it may be considered long-term capital gain rather than ordinary income without regard to section 117(m), will be considered ordinary income under section 117(m)(1).

In the event of the existence of additional facts and circumstances in the above case, the corporation, notwithstanding the above facts, might not be considered a collapsible corporation. See (*b*) and (*d*)(1) of this section.

Example (*2*). On January 2, 1950, B formed the X Corporation and became the sole shareholder thereof. This corporation completed the construction of an office building in 1950. Immediately after the completion of the building, the corporation sold this building at a gain of $50,000, included this entire gain in its return for 1950, and distributed this entire gain (less taxes) to B. The corporation completed the construction of a second office building in June 1951. In August 1951, B sold the entire stock of the X Corporation at a gain of $12,000, which gain is attributable to the second building. In view of the fact that B sold stock of the X Corporation and realized a gain attributable to the second office building, that, at the time of such sale, the corporation had not realized a substantial part of the net income to be derived from such building, and that the construction of such building during the time of such construction was a substantial activity of the corporation, the X Corporation is considered a collapsible corporation under (*d*)(2) of this section. Since the provisions of section 117(m)(3) do not prohibit the application of section 117(m)(1) to B the gain of $12,000 to B is, accordingly, considered ordinary income.

Example (*3*). The facts in this example are the same as in example (2), except that the following facts are shown: B was the president of the X Corporation and active in the conduct of its business. The second building was constructed as the first step in a project of the X Corporation for the development for rental purposes of a large suburban center involv-

ing the construction of several buildings by the corporation. The sale of the stock by B was caused by his retiring from all business activity as a result of illness arising after the second building was constructed. Under these additional facts, the corporation is not considered a collapsible corporation. See (*b*) and (*d*)(1) of this section.

* * * * *

U.S. GOVERNMENT PRINTING OFFICE 1955

IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 476

BENJAMIN BRAUNSTEIN and DIANA BRAUNSTEIN; Estate of Benjamin Neisloss, Deceased, JULIA NEISLOSS and RUSSELL NEISLOSS, Executors, and JULIA NEISLOSS; HARRY NEISLOSS and LILLIAN NEISLOSS, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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REPLY BRIEF FOR PETITIONERS

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IN THE

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No. 476

Benjamin Braunstein and Diana Braunstein; Estate of Benjamin Neisloss, Deceased, Julia Neisloss and Russell Neisloss, Executors, and Julia Neisloss; Harry Neisloss and Lillian Neisloss, *Petitioners*,

v.

Commissioner of Internal Revenue, *Respondent*.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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REPLY BRIEF FOR PETITIONERS

Apparently the Commissioner is not too pleased with the opinion of the Court of Appeals. The court agreed that the corporations were not used as a means of converting ordinary income from the development into capital gain. Moreover, the court unkindly indicated that to apply the statute in such circumstances

"produces unwarranted taxation of capital gains as ordinary income." (R. 36.) In an effort to compensate for these difficulties the Commissioner's brief consists largely of arguments that have not been made before. These arguments are designed to re-rationalize the decision below on something more than a so-called "literal" reading of the statute. Since the Commissioner has felt obliged to go off in new directions, this brief is necessarily much more extensive than it would otherwise have been. However, the Commissioner has left us little choice in the matter.

The resolution of this case turns on the meaning of the words "gain attributable to such property" in section 117(m). The Commissioner, it seems, does not entirely understand our position—indeed, he apparently regards it as mere pretense. (Resp. 16.) Hence we deem it appropriate to restate our views before examining his various arguments and assertions.

Section 117(m) is a special statute designed to cope with a particular problem. This problem is the use of certain corporations as a means of executing a certain scheme of tax avoidance. The corporations involved are entities "formed or availed of for the manufacture, construction, or production of property." The planned avoidance consists of realizing as a capital gain the regular business profit from the property—profit normally taxable as ordinary income to the corporation, or to the stockholders if they individually produced, owned, and operated the property. This conversion of ordinary income into capital gain is effected through a sale or exchange of stock in the corporation. Therefore, section 117(m) provides that the profit realized on the sale of the stock is taxable

as ordinary income only if the property was produced with a view to (1) the shareholders' sale or exchange of the stock before the corporation itself realized a substantial part of the net income to be derived from the property; and (2) the shareholders' realization of "gain attributable to such property." The "gain attributable to such property" is the profit which would be regularly realized as ordinary income from the property in the absence of the scheme to avoid. As the Court recently stated in analogous circumstances, it is "a substitute for what would otherwise be received at a future time as ordinary income" from the property. *Commissioner* v. *Lake*, 356 U.S. 260, 265 (1958). See Pet. 25. The purpose of section 117(m), then, is to reach a disposition of stock which attempts to "make a transaction something else than it truly is." Cf. *Commissioner* v. *Wodehouse*, 337 U.S. 369, 410 (1949).

Here we do not have any such situation. The sale of the stock did not enable the petitioners to transform ordinary income from the property—the profits "arising from the everyday operation of a business"—into capital gain. Cf. *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 52 (1956). See Pet. 51, 79. If the corporations had sold the development, the resulting profit would have been a capital gain. And if the petitioners had individually built and owned the development, the profit would have also been a capital gain. (Pet. 38-39.) The problem with which the Treasury and Congress were so rightfully concerned is nowhere in sight. The Treasury has not been deprived of any tax to which it is otherwise entitled. In fact, the Treasury is better off than it would have been if the petitioners had built and owned the development as individuals. See pp. 51-

52, *supra*. Finally, the Treasury's interpretation perverts the statute. It converts capital gain into ordinary income merely because taxpayers conduct their business through a corporation, and realize a profit through a sale of stock rather than the underlying property. The Court of Appeals itself conceded that its decision was not in accord with the stated policy and design of the statute. (Pet. 78-79.)

We now turn to the contents of the Commissioner's brief. In our view his arguments rest on a number of misconceptions both of law and of fact. Moreover, much of his discussion proceeds on the pleasant premise that taxation is a matter of pure reason, in which he may freely speculate to suit himself.

THE COMMISSIONER'S STATEMENT OF THE QUESTION PRESENTED

The Court has granted certiorari limited to the following question: "Whether Section 117(m) of the Internal Revenue Code of 1939, which provides that gain 'from the sale or exchange . . . of stock of a collapsible corporation' is taxable as ordinary income rather than capital gain, is inapplicable in circumstances where the stockholders would have been entitled to capital-gains treatment had they conducted the enterprise in their individual capacities without utilizing a corporation." (R. 42.) The writ was confined to this question in response to the Commissioner's request. Indeed, the question is in precisely the language as he proposed it. Brief for Resp. on Pet. for Cert. 1-2.

Evidently the Commissioner has become unhappy with the result of his prior efforts. Instead of abiding by the question expressed in the Court's order, he would now improve upon it. The question, as re-

vised by him on his own, is "whether the application of" section 117(m) "is dependent upon a finding in each case that there was no other way for the stockholders to convert the values created by the construction into capital gain." (Resp. 2.)

It is quite obvious why the Commissioner is anxious to rewrite the question. If taxpayers individually construct and operate a development as rental property, the profit realized on a later sale is a capital gain. Int. Rev. Code of 1939, § 117(j). The fact that they contributed their services to the construction is immaterial. Congress regards the difference between the cost and the proceeds as a true capital gain. See further pp. 26-27, *infra*. The purpose of the altered question is to insinuate that the treatment prescribed by Congress is a loophole, and that builders are inherently tax avoiders—converting ordinary income into capital gain—whether they construct and operate their rental properties as individuals or through corporations. In this way the Commissioner hopes to envelop the case in what he considers an appropriate atmosphere. See further pp. 37-38, *infra*.

THE COMMISSIONER'S SUMMARY OF THE FACTS

The Commissioner's statement includes many items which the Court of Appeals considered wholly irrelevant to the question presented here. Compare Resp. 2-8 with R. 35-39. These items are largely concerned with the cost of constructing the development. As we later indicate, they are now imported into the case in a belated effort to find some new ground for sustaining the decision below. See p. 32, *infra*. As we further show, the Commissioner has thoroughly misunder-

stood, the figures as they relate to the builder's and architect's fees. See pp. 40-43, *infra*.[1] At this point we merely note that he has been less than fully accurate in regard to other items—aside from their irrelevance to the question before the Court.[2]

THE COMMISSIONER'S ARGUMENTS ON THE LAW

On analysis, the Commissioner's contentions boil down to three arguments. The first is that the profit realized on the sale constituted the required "gain," regardless of whether any ordinary income from the property was converted into capital gain. The second is that the profit was necessarily a conversion of ordi-

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[1] The Commissioner implies that the F.H.A. expected the eventual cost of construction to include the payment of builder's and architect's fees. (Resp. 5.) However, the F.H.A. knew well in advance that, in accordance with its established procedures, no such fees were to be paid. The amounts attributed by the F.H.A. to such fees were a means of computing the amount of the mortgage loan. See p. 40, *infra*.

[2] For example, the Commissioner states that there were substantial savings in construction "attributable largely to the fact" that the building partnership "did not (as the estimates had assumed the builder would) contract out the carpentry, plumbing, and heating work but performed the work itself, thereby effectively eliminating from the costs the subcontractors', as well as the builder's and architect's, normal mark-up." (Resp. 5.) The Commissioner fails to add, as the Tax Court found, that the savings were unexpected, not planned. (A. 227-228.) See further p. 46, *infra*. Or, to cite another example, the Commissioner states that "by September 1, 1949, all units were occupied." (Resp. 6.) The evidence is precisely to the contrary. The units were never fully occupied while the petitioners owned the stock in Springfield and Hill. In the first five months of 1950 the vacancies for apartments and garages averaged about 9 percent per month. By September, 1950—the time originally fixed for the closing—the vacancies stood at 13 percent. These percentages reflect the ratio of total vacancies to total gross potential rents as stipulated by the parties. (A. 237.) See also Pet. 5, 7.

nary income into capital gain because the corporations engaged in the construction of property. The third is that in any event the proceeds represented a conversion of compensation for services. The second and third arguments are advanced here for the first time. Until now the Commissioner has been unaware of those contentions, and has relied on the first argument alone. We will now consider the three arguments in the same order.

I. THE FIRST ARGUMENT

The animating legislative policy enclosed within section 117(m) is to prevent normal business profits on constructed property from being realized as capital gain. We are happy to say that the Commissioner "fully" agrees. The "admitted" and "basic purpose of the statute," he states, "is to prevent the conversion of ordinary income into capital gain." (Resp. 9, 17, 22.) He also goes a significant step further. He commendably emphasizes that "statutory language should be read—indeed, even strained to some degree—to avoid absurd results, to carry out the discovered purposes of Congress, and in general, in an effort to produce a rational, sensible structure." (Resp. 18.) Nevertheless, the Commissioner incongruously argues that section 117(m) applies here, regardless of whether the sale of stock effected the required conversion. (Resp. 8, 14.) Despite the conceded fact that the Treasury and Congress were solely concerned with ordinary income masquerading as capital gain, the Commissioner contends that "the underlying nature of the gain" is entirely immaterial. (Resp. 14.) In short, as we understand his position, in this case, unlike other cases, the Court need not be concerned about

"absurd results," "the discovered purposes of Congress," and "a rational, sensible tax structure." The asserted deficiencies must be sustained, no matter how absurd and irrational the result may be. Or, to put it a little differently, the Commissioner is prepared to justify Mr. Bumble's celebrated observation that "If the law supposes that," then "the law is a ass."

The Commissioner offers several reasons in behalf of this peculiar conclusion. Apparently his basic reason is that "the words of the statute are quite incapable of carrying the meaning that petitioners would give them." Then he adds these other reasons: Our construction "conflicts with the regulations; is contrary to the settled assumptions of commentators, litigants, and the courts for many years; and would make a nullity of an express, and much narrower, limitation later added by Congress." (Resp. 9.) Each of these explanations leaves a good deal to be desired.

The first reason is a renewed resort to the so-called "literal" words of the statute. However, the Commissioner is unwilling to leave his position so bare, and so he adds a number of embellishments. For example, he dwells on the alleged "textual difficulties in making the words of the statute mean what petitioners would have them mean." (Resp. 15.) But at no point does he reveal the nature or extent of the supposed "difficulties."[3] He next suggests that the word "gain" gen-

[3] The Commissioner devotes some effort to establishing that the words "attributable to" relate to the constructed property. (Resp. 15.) The dispute here is over the nature of the "gain" on which the statute hinges. The Commissioner himself finally realizes this, and addresses himself to the meaning of "gain". (Resp. 16-18.)

erally has a single settled meaning throughout the Code. (Resp. 16.) Yet he also concedes that other words in the Code—like "income," "gift," and "property"—have a variable meaning in the light of "underlying statutory policy and the needs of a rational and workable tax structure." (Resp. 18.) According to the Commissioner, then, the word "gain" is distinctly different from the word "income." In fact, it is one of those rare words that has only one meaning or content. This Court,[4] as well as other courts,[5] has not found that "gain" is so simple and uniform in meaning as the Commissioner would now like to believe. Even where the Code specifically defines a word commonly used in its various provisions, it circumspectly adds that the definition applies only "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof." Int. Rev. Code of 1939, § 3797(a). The ultimate and controlling consideration always is the policy that a term was designed to express in its particular context. (Pet. 45-46, 67-68.) Cf. *Associated Telephone & Telegraph Co.* v. *United States*, 306 F. 2d 824, 832 (2d Cir. 1962), *cert. denied*, 371 U.S. 950 (1963), which resolves a question of interpretation quite differently from the decision below.

Apparently even the Commissioner realizes that a word like "gain" is susceptible to varying meanings,

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[4] Compare the varying views in *Gray* v. *Darlington*, 15 Wall. 63 (1872); *Hays* v. *Gauley Mountain Coal Co.*, 247 U.S. 189 (1918); *Lynch* v. *Turrish*, 247 U.S. 221 (1918); *Merchants' Loan & Trust Co.* v. *Smietanka*, 255 U.S. 509 (1921); and see discussion in Magill, Taxable Income 103 et seq. (rev. ed. 1945). See further the different views expressed in *James* v. *United States*, 366 U.S. 213 (1961); and Pet. 43.

[5] *E.g.*, compare *M. F. Reddington Co.* v. *Commissioner*, 131 F. 2d 1014 (2d Cir. 1942), with *Sicanoff Veg. Oil Corp.* v. *Commissioner*, 251 F. 2d 764 (7th Cir. 1958).

too. Hence he falls back on the further observation that "in a statute articulated in such great detail as § 117(m)," no room is available "for the kind of extensive rewriting" which, in his view, the petitioners are seeking. And for good measure he quotes Judge Learned Hand as stating, in the well-known *Gregory* case, that "as the articulation of a statute increases, the room for interpretation must contract." (Resp. 18.) See *Helvering* v. *Gregory*, 69 F. 2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1934). We regret that the Commissioner did not continue to read more of Judge Hand's rewarding opinion, instead of merely satisfying himself with the few words quoted. For the point made by Judge Hand is precisely the point made by us here—as well as the very point made by the Commissioner himself in the *Gregory* case. That case involved the reorganization statutes, which are easily as articulate as section 117(m). The taxpayer, like the Commissioner here, argued that since those statutes were meticulously phrased, there was nothing to construe. See 27 B.T.A. 223, 225 (1932). Judge Hand answered as follows in behalf of the Commissioner's position: "It is quite true . . . that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create." Judge Hand went on to hold that the "purpose of the section is plain enough," and construed its words in the light of that purpose and "the underlying presupposition." 69 F. 2d at 810-811. Our position here is exactly the same.

Moreover, the definition of a collapsible corporation in section 117(m) is hardly so unusually elaborate as the Commissioner suggests. It is a very typical provision of the Code, phrased in everyday English. See p. 56, *infra*. In terms of detail, it is not particularly different from the basic provisions on capital gains in section 117, which are thoughtfully construed in accordance with the purposes of Congress. (Pet. 22-26.) At any rate, it goes without saying that this Court is much more concerned with good sense, in response to those purposes, than the number of words in a statute. If we may borrow from the Commissioner, the demands of "underlying statutory policy and the needs of a rational and workable tax structure" (Resp. 18) control the meaning of section 117(m), just as they determine the content of other statutes.

In the end, the question before the Court is like the questions resolved in such cases as *Corn Products Co.* v. *Commissioner, supra,* and *Commissioner* v. *Lake, supra,* which also dealt with section 117. Is the profit realized by the petitioners the gain contemplated by the statute? See Pet. 24-25, 51. The only discernible difference is that the Commissioner uses one standard of construction for taxpayers and another for himself. However, we are sufficiently old-fashioned to believe that the Commissioner should not indulge in double standards. Taxpayers are entitled to more than such shifting criteria of right and wrong. And so we deem it appropriate to quote what the Commissioner himself successfully argued in those cases.

For that matter, in the *Corn Products* and *Lake* cases, the problem of construction was more involved because of the internal structure of section 117(a). That statute defines "capital assets" as "property

held by the taxpayer (whether or not connected with his trade or business)"—subject to several exceptions. The property sold in each case did not fall within any of the exceptions. Nevertheless the Commissioner contended that neither property was a capital asset. The following excerpts from his arguments nicely summarize the proper standard of construction for the Commissioner and taxpayers alike. In the *Corn Products* case the Commissioner emphasized that the decisive consideration is to avoid doing "violence to the basic purpose and scope of Section 117." The question always is "the kind of gain" involved. "As this Court has indicated, the capital gains provisions must be read in the light of their purpose and in the context of the pattern of the income tax law which taxes ordinary income at full rates and grants exceptional treatment to capital gains and losses." Brief for the Respondent, pp. 19, 21, 27.[6] In the *Lake* case the Commissioner similarly stated that "the statute must be interpreted and applied so as to effectuate the manifest purpose of Congress." And, he then added, "the statutory language is not to be interpreted literally or according to its usual meaning when to do so would thwart that purpose." Brief for the Petitioners, p. 26.[7] All these statements equally apply here, even

[6] The Commissioner also reasoned that the statutory treatment of capital gains must be "narrowly applied" because it is a special exception to the general rule. *Id.* at 19-21. But here he is arguing that a special provision designed to protect the integrity of that narrow exception should be broadly applied well beyond that specific purpose. See further Pet. 52.

[7] Another recent brief of the Commissioner is also well worth quoting for the principles that he normally applies in his own behalf: "This Court has . . . frequently relied upon legislative history even where it was arguable—as it is not here—that the statutory language was unambiguous." "Thus, the important part

though the Commissioner would now put them aside in pursuit of his double standard. When the application of the stated principles favors the Government, he lauds them as the decisive criteria of interpretation. When their application happens to favor the taxpayer, he decries them as a "plea for a judicial, rather than legislative, rescue." (Resp. 17.) And here, indeed, he is trying to use a double standard for construing the very same group of statutes—the capital gains provisions in section 117.

The Commissioner cites another item as a means of enhancing his view of section 117(m). Our interpretation, he states, would require a "highly specific and complex set of standards by which to determine the application of the statute." (Resp. 18.) Again he makes a mysterious observation without adding any informative details. It seems enough to say that there is nothing more complicated here than the usual task of applying legislative standards in specific contexts. Courts do this every day amid varying circumstances. Furthermore, the hearings and committee reports clearly indicate how section 117(m) is to be applied. Certainly, our interpretation—which is precisely the construction that Congress contemplated—does not raise any more problems than a case-by-case application of the *Corn Products* and *Lake* decisions. We can think of few decisions which have created more prob-

which the legislative history plays in determining the meaning of a statute is now a firmly entrenched teaching of this Court." "To disregard the Committee reports in this case would invite unnecessary litigation with respect to many other provisions of the revenue laws, the terms of which are often clarified and explained by reference to the careful statements of the drafting and reporting committees." Brief for the Petitioner, pp. 18-20, in *Commissioner* v. *Bilder*, 369 U.S. 489 (1962).

lems of intelligent administration than various leading cases won by the Government—such as *Helvering* v. *Clifford,* 309 U.S. 331 (1940); *Helvering* v. *Horst,* 311 U.S. 112 (1940); and *Gregory* v. *Helvering, supra.* Hence it is somewhat amusing to see the Commissioner suddenly express acute concern over undue complexity—especially when it is non-existent.

The short of the matter is that the Commissioner is simply pleading for a wooden and "literal" interpretation of the statute. The odds and ends tacked on to the plea do not obscure its true nature. But this resort to "literalism" is mere question-begging. It is the venerable fallacy of one-word-one-meaning. (Pet. 40-41.) And it is also the very kind of construction that the Solicitor General has cogently criticized and deplored. Cox, *Judge Learned Hand and the Interpretation of Statutes,* 60 Harv. L. Rev. 370 (1947).

The Commissioner's next point is that our construction is at odds with the regulations, which apply section 117(m) where the gain is not a conversion of ordinary income from the property. (Resp. 19.) However, the regulations do not add anything to the merits of his position.

As a respected Treasury authority has written, interpretative regulations are "no more than the Department's construction of the Revenue Act. Apart from their binding effect upon the personnel of the Bureau of Internal Revenue, they do not as Regulations possess any authority." Such regulations "considered in their own right enjoy, as respects taxpayers, no greater authority as to the meaning of the statutory language interpreted than is possessed by the discussions in the tax services or legal periodicals." Whatever effect

they have is as an aid to construction "under the principles of statutory interpretation." Surrey, *The Scope and Effect of Treasury Regulations Under the Income, Estate, and Gift Taxes*, 88 U. of Pa. L. Rev. 556, 557-558 (1940). Here they are not entitled to any weight as such aid. The position taken by the regulations does not "embody the results of any specialized departmental knowledge or experience," or serve any administrative "convenience or purpose apart from compliance with the supposed command of the statute. There is thus a complete absence of those reasons which ordinarily lead courts to give persuasive force to an administrative construction and which justify their acceptance of it in preference to their own." *Haggar Co.* v. *Helvering*, 308 U.S. 389, 398 (1940). And, as for "compliance with the supposed command of the statute," the regulations are directly in the teeth of the statute as thoroughly illuminated by its legislative history.[8] Cf. *Trust of Bingham* v. *Commissioner*, 325 U.S. 365 (1945).

There is also something else which the Commissioner naturally fails to mention—that the administrative practice of the Treasury has been conspicuously inconsistent. His present view of the statute contradicts his prior position taken shortly after the statute was

[8] The Solicitor General has properly stressed "a serious weakness" that administrative interpretations "sometimes have"—their "partisanship"; and that this frailty is particularly true of Treasury interpretations. "Under many statutes the position of the public officer charged with administration but lacking power to decide is not, and is not supposed to be, wholly impartial. Treasury officials are collectors of revenue . . . ." Hence "for reasons of partisanship official rulings should be read with caution," and the partisanship "should be taken into account in determining the weight to be given such interpretations by the courts." Cox, *supra*, at 390-392. These thoughtful comments are particularly pertinent here. See p. 17, *infra*.

enacted. His present view, then, does not qualify as a contemporaneous expression of opinion or as a position consistently held. Cf. *Burnet* v. *Chicago Portrait Co.*, 285 U.S. 1, 16 (1932); *Estate of Sanford* v. *Commissioner*, 308 U.S. 39, 51-52 (1939). Our construction only reflects what the Treasury itself held before it decided to improve upon the statute and its policy. Section 117(m) was enacted on September 23, 1950. Regulations were not proposed until over two years had elapsed—on October 9, 1952. And then they were not promulgated until almost another half year had passed—on March 26, 1953.[9] Meanwhile, however, the Treasury had confidently ruled that profits realized with respect to FHA rental developments—profits that were not a conversion of ordinary income from the property—were capital gains. See *Hearings before the Senate Committee on Banking and Currency pursuant to S. Res. 229 (F. H. A. Investigation)*, 83d Cong., 2d Sess. 161, 3469 (1954). One of these rulings was issued on November 30, 1950—about two months after the enactment of section 117(m). For the convenience of the Court this ruling is set forth in Appendix A, *infra*, pp. 1a-2a.[10] As the ruling indicates, there is not the slightest suggestion that section 117 (m) is in any way relevant. Nor does the matter end there. In a number of cases involving FHA rental developments, the Treasury systematically asserted deficiencies on grounds other than section 117(m). It was only later that it decided to switch over to that

[9] 17 Fed. Reg. 9014; T.D. 5999, C.B. 1953-1, 187.

[10] While taxpayers are not entitled to rely on private rulings not addressed to them, "such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws." *Hanover Bank* v. *Commissioner*, 369 U.S. 672, 686-687 (1962).

statute by altering its interpretation. See *Estate of Carl C. Myers,* 15 T.C.M. 750 (1956); *Thomas Wilson,* 25 T.C. 1058 (1956); *W. H. Weaver,* 25 T.C. 1067 (1956); *C. D. Spangler,* 32 T.C. 782 (1959), *aff'd,* 278 F. 2d 665 (4th Cir. 1960), *cert. denied,* 364 U.S. 825 (1960).[11]

The Treasury's eventual change of position, it seems, was inspired by something quite different and distinct from an effort to abide by the statute. After section 117(m) was enacted, concern developed, within and without Congress, over various loans guaranteed under section 608 of the National Housing Act. It was found that in many cases loans had exceeded actual costs of construction. FHA developments acquired a stigma of sharp dealing and unjust enrichment. Evidently the Treasury decided to lend its aid in minimizing the resulting benefits to stockholders in such developments. Section 117(m) was chosen to do the job, and the benefits were subjected to that section, regardless of whether they constituted a conversion of ordinary income from the property into capital gain. In an effort to be helpful, the Commissioner improvised a rule of his own under alleged cover of the statute. In short,

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[11] In the *Myers* case the Commissioner never switched over. In the *Wilson* case the deficiency was initially asserted under section 22(a). "At the hearing, for the first time," he "indicated that to support his determination he was relying on section 117(m) of the Internal Revenue Code of 1939." 25 T.C. at 1066. In the *Weaver* case the Commissioner also rested initially on section 22(a). He first shifted to section 117(m) in an amended answer. "The item of income in controversy" under his amended position "was not even mentioned in the original deficiency notice." 25 T.C. at 1080-1081, 1085. In the *Spangler* case the same pattern was repeated. The Commissioner first introduced section 117(m) into the case through an amended answer filed on November 13, 1957. 32 T.C. at 791.

he confused questions of taxation with problems of business ethics. *Cf. Lilly* v. *Commissioner,* 343 U.S. 90 (1952). But the question here is not whether profits realized on FHA developments were too large. The question is whether Congress enacted section 117(m) in order to tax such profits.

We believe that the course of administrative practice speaks for itself. But the Commissioner himself has nicely illustrated the basic interpretative inconsistency within which the Treasury is enmeshed. In Rev. Rul. 56-50, C.B. 1956-1, 174, 175-176, he declared that "the objective" of section 117(m) "was to prevent the successful use of a device for converting ordinary income into long-term capital gain through the medium of a corporation." Yet at the same time he assumed, for the purpose of the ruling, that profit realized on a sale of stock in a corporation operating a rental development is collapsible income—though the profit was not a conversion of ordinary income any more than it is here.[12] At the very least, administrative reasoning should make internal sense before it seeks judicial approval.[13] Cf. *Trust of Bingham* v. *Commissioner, supra,* at 376-377; and cases cited at p. 16, *supra.*

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[12] In the present case the Commissioner has reversed the procedure. First he argues that a conversion of ordinary income into capital gain is unnecessary. And then he works hard to establish that there was such a conversion here—though he finally gives up. See p. 54, *infra.*

[13] The Commissioner notes, as a further point in favor of the regulations, that they are "intricate and complicated." (Resp. 19.) We are unaware of any doctrine that complexity enhances the authority of Treasury regulations. Moreover, the argument is rather peculiar here, since the Commissioner roundly condemns our own position on the ground of alleged complexity. See p. 13, *supra.* In any event, the intricacies of the regulations have nothing to do with the present question.

Furthermore, the sale in question was made while the Treasury was still satisfied with its original understanding of the statute. The regulations on which the Commissioner now relies were issued about two years after the transaction was consummated. Therefore, they should not be given any retroactive effect here, even if they were otherwise entitled to some weight. Cf. *Commissioner* v. *Goodwyn Crockery Co.*, 63-1 U.S.T.C. ¶ 9369 (6th Cir. 1963). This is not a case like *Helvering* v. *Reynolds*, 313 U.S. 428 (1941), where the prior administrative construction related to a predecessor statute. Here the original construction dealt with the very statute involved, and the sale was made while that construction was still in effect. Cf. Harlan, J., in *Massey Motors* v. *United States*, 364 U.S. 92, 118-120 (1960) (dissent).

The Commissioner also tries to score a few other points in behalf of his first argument. He refers to extensive litigation in regard to FHA developments, and states that "not until" the decision in *United States* v. *Ivey*, 294 F. 2d 799 (5th Cir. 1961), "was it ever suggested" that the statute does not apply to the type of transaction involved here. And then he adds: "The commentators, too, shared the universal assumption of the courts and litigants that the statute did not permit of interpretive relief even if it should operate, in a given case, to reach what would otherwise have been capital gain." Hence, the Commissioner concludes, it is not only the regulations, but "the established understanding of the courts and the tax bar, that petitioners must overcome." (Resp. 19-20.)

If an argument is known by the company it keeps, this strand of reasoning is rather revealing. To begin with, the so-called "assumption" was much less "uni-

versal" than the Commissioner seems to think. At the very outset the Treasury itself construed section 117-(m) as not applying to transactions like the petitioners'. Moreover, the Treasury's present position—that section 117(m) converts capital gain from property into ordinary income—was directly attacked in the Second Circuit and the Tax Court. See *Glickman* v. *Commissioner*, 256 U.S. 108 (2d Cir. 1958); *Carl B. Rechner*, 30 T.C. 186 (1958).[14] However, it seems unnecessary to pursue this matter further. Where the taxpayer cites a contrary line of lower court decisions, the Commissioner is considerably less impressed with the reasoning in which he now engages.[15] As the Court

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[14] Although the Treasury's present construction was directly challenged in the *Glickman* case, the Second Circuit did not discuss the question. See Brief for Petitioners, pp. 39-41, in *Glickman* v. *Commissioner, supra.* In the *Rechner* case the Tax Court disposed of the issue by simply holding that the statute encompasses property held for use in trade or business. But this answer completely misses the issue. No one denies that section 117(m) includes such property. The issue, rather, is whether the profit realized on a disposition of the stock is the "gain" to which the statute is addressed—a conversion of the ordinary income from the property into capital gain—and whether the property was manufactured or constructed with a view to the realization of such a profit. See Pet. 72-76.

[15] Only four circuits—the Second, Third, Fourth, and Fifth—have considered the applicability of section 117(m) to sales of stock in corporations holding property for rental. Of these four, only two—the Second and Fifth—have discussed the question now before the Court—whether the section applies to sales that do not effect a conversion of ordinary income from the property into capital gain. And these two disagreed. It has been well noted that the course of lower court decisions "might have been quite different" if cases other than those involving FHA projects had first reached the courts. Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment*, 58 Col. L. Rev. 1146, 1178, n. 77 (1958). But as the Commissioner recognizes, there is no distinction in principle between the *Ivey* case, which did not involve an FHA project, and this case, which does. See Brief for Resp. on Pet. for Cert. 4.

has stated, "We do not expect Congress to make an affirmative move every time a lower court indulges in an erroneous interpretation. In short, the original language speaks louder than such judicial action." *Jones v. Liberty Glass Co.*, 332 U.S. 524, 533 (1947). And see *Higgins v. Smith*, 308 U.S. 473 (1940), where the Court held that the Government's interpretation was not precluded by decisions of four courts of appeals and a consistent line of decisions in the Tax Court. Otherwise, indeed, this Court's weighty responsibilities as ultimate arbiter would, in effect, be delegated to the lower courts.[16] Cf. *James v. United States*, *supra*, at 220-221.

Little more need be said about the weight attributed to commentators. As one of them has critically observed, "the basic purposes of the original enactment have been forgotten," and the "legislative purpose has been much distorted in the performance." The Treasury's construction has resulted in "converting into ordinary income what would be capital gain in the absence of the corporate form." Anthoine, *supra*, at 1176, 1178. At any rate, until now we had been unaware that the construction of tax statutes resolves itself into a matter of counting heads among commentators. Indeed, the tax bar, like other experts, is very often wrong. Such landmark cases as *Helvering v. Clifford*, *supra*; *Gregory v. Helvering*, *supra*; and *Higgins v. Smith*, *supra*, would

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[16] Cf. *F. W. Woolworth Co. v. United States*, 91 F. 2d 973, 976 (2d Cir. 1937), *cert. denied*, 302 U.S. 768 (1938): "To suppose that Congress must particularly correct each mistaken construction under penalty of incorporating it into the fabric of the statute appears to us unwarranted; our fiscal legislation is detailed and specific enough already." And see Surrey, *supra*, at 564.

never have been decided as they were, if the controlling standard of decision is the understanding of the tax bar.

The Commissioner finally turns to the 1958 amendment for additional help. Once more the reasoning is curious. While the Commissioner concedes that later legislative developments "provide little aid in interpreting an earlier statute," he promptly ignores the concession and attempts to find the desired aid. He dwells upon the theme that the "relief" provided by Congress in 1958 is "much more circumscribed than that sought from the Court," and that this "fact" is "surely relevant when what the Court is asked to do amounts, as here, not to 'interpretation' but to judicial 'correction' of an alleged statutory oversight." Then the Commissioner states: "And if nothing else, the complexity of the 1958 amendments reveals the immense difficulties inevitably encountered in implementing a 'what might have been' standard of liability of the sort petitioners ask this Court to create and define quite without statutory aid." (Resp. 21-22.)

These observations are essentially mere rhetoric. We are not asking the Court for "relief"; we are not asking it to "correct" an "oversight"; and we are not asking it to implement a standard of "what might have been." We are simply asking the Court to construe section 117(m) as the Treasury and Congress contemplated when the statute was enacted, and as the Treasury construed the statute before it changed its mind. And the required standard of application is clearly set forth and illustrated in the legislative hearings. That standard is no more "what might have been" than the standard applied in such cases as *Hort v. Commissioner*, 313 U.S. 28 (1941); and *Commissioner v. Lake*, *supra*. Cf. *Griffiths v. Commissioner*,

308 U.S. 355, 358 (1939); *Helvering* v. *Horst, supra*, at 116-118; *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 612-613 (1938). The question is whether the profit realized on the sale or exchange of stock is a deliberately contrived substitute for what is normally received as ordinary income from the property. (Pet. 24-25.) We cannot understand why the Commissioner should find it more difficult to apply section 117(m) than the *Lake* decision. In one case, as in the other, it is simply a matter of looking at the content of the underlying gain. The only difference between the two is that in one case the substitute for the ordinary income from the property is obtained through a transfer of an interest in the property; in the other case, through a sale or exchange of stock.

Apart from the rhetoric, there is little else in the Commissioner's observations on the 1958 amendment. Indeed, in his very effort—weak as it is—to derive aid from the amendment, he is directly violating the amendment itself. A special provision in the amendment states, in so many words, that in determining whether or not a corporation is collapsible, the fact that it "does not meet the requirements" of the amendment "shall not be taken into account;" and the determination "in the case of a corporation which does not meet such requirements shall be made as if" the amendment "had not been enacted." (Pet. 87.) Or, as the report of the Finance Committee states, the enactment of the amendment "will never result in causing a corporation to be classified as collapsible." (Pet. 85.) The Committee wisely anticipated, as this case shows, that the Commissioner might well try to use the amendment as a means of rationalizing retroactive implications in his favor. And so the Committee

squarely prohibited him from doing what he is now attempting. Here we have not only a later statute, but a later statute which specifically declares that no adverse inferences against taxpayers are to be drawn from it. The courts are instructed to construe the definition of a collapsible corporation as if there were no amendment. In the apt words of Professor Anthoine, the amendment was "intended as a shield, not a sword". Anthoine, *supra*, at 1181.

In short, if the Commissioner's present position has been wrong all along, Congress' expression of concern in 1958 did not make it right. Cf. *White* v. *Winchester Country Club*, 315 U.S. 32, 39 (1942). The fact that Congress dealt with only a segment of a problem "does not imply controlling acceptance by Congress" of the Treasury's current construction. *Helvering* v. *Hallock*, 309 U.S. 106, 120, n. 7 (1940). Tax statutes are enacted amid a cross-current of pressures and counter-pressures exerted by the Treasury and taxpayers. As in many other such cases, the complex 1958 amendment evidently derived from a compromise between the Treasury and Congress, which felt that the legislative policy had been gravely misapplied. The net result was an *ad hoc* solution confined to the most pressing cases before Congress. See the illuminating analysis in Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted*, 70 Harv. L. Rev. 1145, 1161-1163 (1957). In submitting the amendment, the Finance Committee did not remotely approve the construction which prompted it. In fact, the Committee explicitly criticized the construction as inflicting an "unintended hardship" on taxpayers. It produces "exactly the opposite effect from that intended" by converting bona fide capital

gains into ordinary income. (Pet. 82-86.) The fate of that construction was left to the fair adjudication of the courts, in the light of the purposes which prompted the enactment of section 117(m). Finally, corrective tax statutes often turn out to be unnecessary after having been enacted to resolve doubts or foreclose undesirable consequences, reflected or threatened by pending controversies. See, *e.g.*, *Burnet* v. *Guggenheim*, 288 U.S. 280, 283 (1933); *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312, 322 (1934); *United States* v. *Stewart*, 311 U.S. 60, 66-68 (1940); *Commissioner* v. *Estate of Holmes*, 326 U.S. 480, 487-488 (1946). Cf. *Higgins* v. *Smith*, *supra*, at 479-480. See also Pet. 87-89. As the Government argued in *Higgins* v. *Smith*, *supra*, amid cognate circumstances, "Indeed it would be most ironical if the solicitude of Congress in meeting an evil with particularity should be taken to have foreclosed consideration of doubts under existing law which might be resolved in accord with the law as enacted for the future." Brief for the Petitioner, p. 31.

II. THE SECOND ARGUMENT

This argument now makes its appearance for the first time. Of course, a new argument is not necessarily a better one. Here it only serves to confirm again that the Commissioner is turning the statute upside down. In the words of the Finance Committee, he is trying to "convert what would otherwise be capital gain into ordinary income." (Pet. 83.)

The Commissioner's reasoning is simple. Having argued at some length that the statute applies, regardless of the nature of the gain involved, he now contends that any values realized through the construction of

property are inherently ordinary income. Therefore, as we further understand the reasoning, stock proceeds which reflect the same values are necessarily conversions of such ordinary income. As the Commissioner puts it, a gain realized on a sale of constructed property is "a gain of a fundamentally different character from the kind of long-term appreciation in value, due to changes in market conditions." On the basis of this observation he then concludes: "In § 117(m), Congress has simply made the judgment that such construction and manufacturing profits are in their 'nature' ordinary income, and ought to be taxed as such rather than be allowed to be 'converted' into capital gain through stock sales. That eminently sensible policy judgment provides a complete explanation both of the purpose and of the language of the statute. To confine the statute to its purpose of preventing the 'conversion' of ordinary income into capital gain, the Court need only apply it as written." (Resp. 9, 23.)

This argument illustrates what Dean Griswold describes as "thinking great thoughts about a tax problem" without the benefit of any relevant statute. Griswold, Cases and Materials on Federal Taxation 15 (3d ed. 1950). The various observations are wholly removed from the actual policies and legislation of Congress. The mere fact that the Commissioner may not like those policies does not make them less real. As the court below also recognized (R. 35-37), Congress' views in regard to constructed property are quite different from those now so freely attributed to it. If three individuals construct an apartment building and later sell it, the profit realized on the sale is ordinary income or capital gain, depending on whether the property is held primarily for sale to customers in

the ordinary course of their trade or business. If the property is so held, the profit is ordinary income. If it is not so held, the profit is capital gain. Int. Rev. Code of 1939, § 117(a)(1) and (j)(1). Again, if the same three individuals construct and own the building through a corporation, which later sells the building, the tax on the profit similarly turns on whether the corporation holds the property primarily for sale to customers in the ordinary course of its trade or business. In other words, the fact of construction by the taxpayers involved is completely immaterial. As even the Commissioner concedes, apart from artistic compositions and similar properties, section 117(a)(1) and (j)(1) does not make any distinction "between purchased and created property." (Resp. 30, n. 27.)[17] The answer hinges on the underlying nature of the gain, as determined by the nature of the holding.

The clear policy of Congress, then, is that profit realized on a sale of property constructed by the taxpayer, whether individual or corporate, is capital gain—as long as the property is not held primarily for sale to customers in the ordinary course of business. By the same token, there is no conversion of "ordinary income" into "capital gain," as Congress understands

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[17] The Commissioner finds it "interesting to speculate" whether the courts are not beginning to recognize some difference in "problems" between "taxpayer-created properties" and "purchased properties." (Resp. 30, n. 27.) His speculations quietly ignore the relevant cases. It is hornbook law that the nature of a gain realized on a sale turns on the purpose for which the property was held in relation to the taxpayer's business—not on whether the property was constructed or purchased by him. See, *e.g.*, *Victory Housing No. 2* v. *Commissioner*, 205 F. 2d 371 (10th Cir. 1953); *McGah* v. *Commissioner*, 210 F. 2d 769 (9th Cir. 1954); *Goldberg* v. *Commissioner*, 223 F. 2d 709 (5th Cir. 1955); *Curtis Company* v. *Commissioner*, 232 F. 2d 167 (3d Cir. 1956).

these words, if the same profit is realized through a sale of stock rather than a sale of the property itself. The Commissioner is, in effect, arguing that in the exercise of an "eminently sensible policy judgment," Congress provided that a profit which is plainly a capital gain acquires "a fundamentally different character" if it happens to be realized through a sale of stock. And this "eminently sensible policy judgment" is then described as "a complete explanation" of what Congress has done. We respectfully submit that Congress is entitled to much more respect in the process of construing its statutes.

If any doubts remain, they should be fully removed by the legislative history of another provision in section 117—subsection (a)(1)(C), which is supplemented by subsection (j)(1)(C). Subsection (a)(1)(C) states that "capital assets" do not include "a copyright; a literary, musical, or artistic composition; or similar property"; held by "a taxpayer whose personal efforts created such property."[18] This subsection and subsection (m) of section 117 were enacted at the same time. And, as the committee reports indicate, they are in *pari materia* and must be closely construed together.

Subsection (a)(1)(C) originated in the Ways and Means Committee, and initially included patents as well as copyrights and other artistic compositions. The Committee explained that under the then existing law a basic line was drawn between professionals and amateurs who derived income from a sale of a book or an

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[18] The subsection provides similarly with respect to a taxpayer whose basis for such property is determined by reference to the basis in the hands of "the person whose personal efforts created such property."

invention. The profit of the professional was ordinary income, "since the products of his work are held by him 'primarily for sale to customers in the ordinary course of his trade or business' and are, therefore, not treated as capital assets." In contrast, the profit of the amateur was capital gain if he held "his invention or book or other artistic work for 6 months," because it was "not held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. As a result the taxpayer receives long-term capital gains treatment on the product of his personal effort." The Committee concluded that "when a person writes a book or creates some other sort of artistic work or devises an invention with the idea of realizing income on it he should be treated as being in the trade or business of writing, creating, or inventing, regardless of whether the income from his personal efforts is realized through royalties or through outright sale, and regardless of the fact that this is the first time he may have engaged in such a trade or business." H.R. Rep. No. 2319, 81st Cong., 2d Sess. 54 (1950). The Finance Committee eliminated inventions from the amendment, and the subsection, as so revised, was approved in conference. Sen. Rep. No. 2375, 81st Cong., 2d Sess. 43 (1950); Conf. Rep. No. 3124, 81st Cong., 2d Sess. 27 (1950).

For present purposes we are concerned with the amendment only as it relates to the operation of section 117(m). In this respect the committee reports are particularly informative. Both reports note that the amendment denying capital gain treatment covers, not only copyrights, and literary, musical, or artistic compositions, but also "similar property." Such "similar property" includes "a radio program which

has been created by the personal efforts of the taxpayer." On the other hand, the reports pointedly state, "The interest of a sole proprietor in such a business enterprise as a photographic studio is not 'similar property' even though the value of the business may be largely attributable to the personal efforts of the sole proprietor." The reports then specifically indicate that the amendment and section 117(m) are interrelated provisions that work together. The amendment, they explain, does not cover "the situation in which the taxpayer contributes a copyright or similar property created through his personal efforts to a newly formed corporation in exchange for its stock and then sells the stock since such situation is dealt with" in section 117(m), added to the Code by the same bill. H.R. Rep. No. 2319, *supra*, at 92-93; Sen. Rep. No. 2375, *supra*, at 84. See also Reg. 111, § 29.117-1, as amended by T.D. 5881, C.B. 1952-1, 56, 57. Section 117(m), then, was designed to prevent the avoidance, through incorporation and a sale of stock, of the ordinary tax imposed on a sale of the property covered by the amendment.

Two conclusions readily emerge from this chapter of legislative history. First, except for copyrights and similar property within subsection (a)(1)(C), property produced and held by the taxpayer qualifies as a capital asset, and a profit realized on its sale is a capital gain—as long as the property is not held primarily for sale to customers in the ordinary course of business. The extent of the personal services contributed to the production of the property is immaterial. The reports expressly cite a photographic studio, where the appreciation realized on a sale is "largely attributable to the personal efforts" of the taxpayer. Even

a patent—which uniquely derives from individual ability and resourcefulness—qualifies as a capital asset. And so we need hardly add that a profit realized on a sale of a typical apartment building is *a fortiori* a capital gain, even though the success of the enterprise may be largely due to the personal efforts of the owners. We are only summarizing hornbook tax law. Everyday taxpayers sell business properties, not held for sale in ordinary course, to which they have devoted their energies and talents. And the gains realized in such transactions are uniformly taxed as capital gains.

Second, the committee reports explicitly coordinate section 117(m) with copyrights and similar property, as distinguished from other property to which the taxpayer may have contributed his personal efforts or skills. And they do so because the profit realized on a disposition of copyrights or similar property is taxed as ordinary income. Otherwise the taxpayer will be able to convert ordinary income into capital gain through a sale of stock instead of the copyright. But to apply section 117(m) similarly with respect to other properties would make nonsense out of the reports. A patent and a photographic studio are again apt illustrations. As we have seen, the Finance Committee insisted, and the Ways and Means Committee eventually agreed, that profits derived from a sale of a patent is a capital gain, if the patent is not held primarily for sale to customers in the ordinary course of business. Surely, the committees did not at the same time contemplate that if the invention were devised in a corporation, the profit on the sale of the stock would be ordinary income. Again, both committees emphasized, by way of example, that a photographic studio largely developed through the personal efforts of its owner is

a capital asset, and that a profit on its sale is a capital gain. Surely, the committees did not contemplate that if the taxpayer developed the same studio through a corporation, the same profit realized on a sale of stock would be ordinary income. And what the reports so plainly reveal applies no less to run-of-the-mine apartment buildings.

To restate our conclusion in the form of two questions, if profits realized on a sale of constructed property "are in their 'nature' ordinary income" (see p. 26, *supra*), then why are such profits taxed as capital gains if realized by the corporation itself or by individual owners on a direct sale of the property? And, second, if Congress set out to reach profits which are otherwise normally taxable as capital gains, then why did it make the application of section 117(m) turn on the purpose or motive with which the property was constructed? A tax avoidance statute carefully geared to purpose is necessarily concerned with attempted improprieties. As the Commissioner understands the section, Congress proscribed as tax avoidance a corporation used to construct property and realize a capital gain which Congress otherwise regards and taxes as a capital gain. See Pet. 61-63. And such an interpretation is deemed a faithful adherence to the purposes and policies of Congress.

III. THE THIRD ARGUMENT

The final argument is another attempt to re-rationalize the decision below. This new effort is adorned by vivid verbiage, which is supposed to suggest an insidious intrigue against the revenue. If an argument alone will not do, perhaps dramatic license will help. But all the colorful words do not obscure the mistakes and misconceptions on which the argument rests.

This case, the Commissioner states, "is an extreme and flagrant example of the very abuse at which the statute was directed: the conversion into capital gain of the normal profits generated by the manufacture, construction, or production of property." And, in an effort to be more persuasive, he also states that the conversion is "blatant" and "most blatant." (Resp. 9, 22, 25, 36-37.)[19] He then tries to justify his rhetoric by focusing on the profit derived from the sale of stock in Springfield. The petitioners—the argument runs—"were able two years later to dispose of it for $683,500 for only one reason: by charging the corporation nothing for architectural, general contracting, and subcontracting services estimated to cost over $700,000, they had created for the corporation buildings worth $683,500 more than their actual cost. In short, petitioners contributed their services to create a valuable property for the corporation and then real-

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[19] Now and then the Commissioner tries to derive some obscure significance from the fact that the petitioners paid only $30 for their stock in each corporation. (Resp. 9, 14, 25.) We fail to understand the relevance of this item. Moreover, again the Commissioner is less than complete in stating the facts. First, the petitioners supplied the land on which the development was built. (A. 190, 192.) Second, they provided 99-year leaseholds for the two corporations. (A. 200, 215.) Third, the National Housing Act contemplated that construction costs would be largely financed through borrowed capital under a program of federal insurance. The very purpose of the Act was to encourage builders, like the petitioners, to construct apartment developments under such terms. The petitioners simply proceeded in accordance with this program as administered by the F.H.A. No additional equity capital was placed in the enterprise because no more was required. Both corporations had sufficient capital for their needs. The Commissioner seems to be under the impression that the larger the sum risked, the better the investment. In our system of private enterprise investors commonly embark upon financial ventures with borrowed funds. And they put in only so much of their own money as is necessary.

ized upon that value by selling their stock." If they had adequately charged for their services, "they would have ended up with contruction profits of $706,979, taxable to them as ordinary income." The proceeds of sale "resulted plainly and simply from the conversion of the value of their contributed construction services. In a word, they took out of the corporation in the form of proceeds from the sale of stock neither more nor less than what they put into it in the form of contributed services." (Resp. 9-10, 24-25.)[20]

The essence of this contention is clear. The Commissioner has seized on the phrase "conversion of ordinary income," which appears in the hearings and reports, to build an argument that has little to do with the meaning of the phrase as used there. As the hearings and reports make clear, the ordinary income with which section 117(m) is concerned is the ordinary income that normally flows from the constructed property. The abuse it seeks to prevent is the transformation of that income into capital gain. The Commissioner tries to sustain his position by isolating and quoting a fragment of legislative history. (Resp. 33.) In this detached fragment President Truman stated that actors had joined with producers in setting up collapsible corporations. (Pet. 27.) But as the legislative history fully indicates, the compensation that may or may not be paid to a particular stockholder is immaterial in determining whether a corporation is

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[20] In his effort to dramatize, the Commissioner exaggerates. He implies that the petitioners went looking for a buyer. (Resp. 25.) In the spring of 1950—substantially after the development was completed—a number of brokers approached the petitioners, but they refused to negotiate. (A. 127-128.) The petitioners never listed the property with brokers. (A. 127-128, 169.) The negotiations which led to the sale were initiated by brokers on behalf of the purchasers. (A. 135, 136, 167, 243.)

collapsible. The critical vice of the collapsible corporation is the planned conversion of the ordinary income *from the property* into capital gain before the corporation itself realizes a substantial part of the ordinary income *from the property.* See *Hearings before the Committee on Ways and Means on Revenue Revision of 1950,* 81st Cong., 2d Sess. 70; and Pet. 28-35. None of the examples given in the hearings and reports evinces the least interest in whether the stockholders— be they producers or builders—are adequately compensated for their services to the corporation.[21] In every example there is the same single-minded emphasis on only one thing—the studied failure of the corporation to derive ordinary income from the property produced or constructed before the stockholders convert that income into capital gain. Otherwise the substantial legislative materials are a meaningless collection of words. Certainly, they make no sense if the Commissioner's present view of the statute is correct.[22]

[21] The President, in short, mentioned actors, as well as producers, not to define the nature of a collapsible corporation, but to indicate that actors, who normally do not own motion pictures, could also be given shares in such corporations as compensation for services. On the other hand, the nature of the collapsible corporation itself was repeatedly summarized as a device deliberately used to transform ordinary income from the constructed or manufactured property into capital gain. Of course, if an actor obtains stock as compensation for services, the value of the stock is immediately taxable as ordinary income. Reg. 111, § 29.22(a)-3. In any case, here the petitioners did not receive any stock for services. (A. 249.) Moreover, in 1950 Congress specifically dealt with the special kind of property, to which actors contribute their unique efforts, through subsection (a)(1)(C) of section 117, in conjunction with subsection (m). See pp. 28-31, *supra.*

[22] The Commissioner charges us with using some so-called "model" for determining when section 117(m) applies—"one that involves a particularly great restructuring of the transaction." (Resp. 10, 14-15, 26.) We are not seeking to "restructure" any-

What is so plainly shown by the legislative history is confirmed by the statute itself. Under section 117(m) no problem of collapsibility can arise unless the stock is sold or exchanged "prior to the realization by the corporation" itself "of a substantial part of the net income to be derived from" the property. And that net income is the ordinary business profit realizable by the corporation "in its normal business operations." (Pet. 65.) The compensation paid or not paid to stockholders is irrelevant. Clearly, if Congress had intended to define collapsibility in terms of a conversion of compensation, as distinguished from a conversion of ordinary income from the property, it would have said so. Nor do the regulations remotely include any such theory of conversion as the Commissioner is now espousing. The regulations state that whether a corporation is collapsible shall be determined "on the basis of all the facts and circumstances in each particular case." Reg. 111, § 29.117-11(d). But not one provision or example reflects the slightest concern with the adequacy or reasonableness of compensation received by stockholders.

All in all, the Commissioner's argument here is essentially the same as his second argument, though it is more elaborately stated. And hence it is enmeshed in the same difficulty. There was no conversion of

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thing. We are simply construing "gain" attributable to the constructed property as the Treasury and the tax committees contemplated. And we are merely applying the same norms that they used. See Pet. 27-38; see p. 13, *supra*. The Commissioner further observes that "persons using the corporate form" must "accept the tax consequences of their choice." (Resp. 32, n. 29.) We have no desire to quarrel with this generality, for there is no attempt here to disregard the corporate form. The question is how the profit realized on the sale of the stock is to be taxed. Compare section 115(g), relating to the taxation of disguised dividends.

"ordinary income into long-term capital gain through the medium of a corporation." See p. 18, *supra*. If the corporations had sold the development—or if the petitioners had individually owned, operated and sold it—the profit on the sale would have been a capital gain. The personal services of the petitioners, no matter how substantial, would be irrelevant. Whether they were paid or not would be equally irrelevant. In 1950 the tax committees squarely confirmed the basic policy to this effect, subject to one exception. See p. 28, *supra*.[23] But, as the Commissioner would have it, at the very time the committees confirmed this basic policy, they also provided that if the same profit is realized through a sale of stock, it is taxable as disguised compensation. Even the Commissioner is somewhat embarrassed by such strange incongruities. (Resp. 29.) For, in effect, he is converting capital gain into ordinary income because the enterprise happened to be incorporated and the petitioners sold stock instead of assets. And so he tries to supply a satisfactory explanation for the absurdity that he attributes to Congress. If the same profit, he states, is otherwise commonly realized and

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[23] This one exception relates to copyrights, artistic compositions, and "similar property." But even gains realized on a sale of such assets are not taxed as compensation for services. They are taxed as gains realized on a sale of property held for sale to customers in the ordinary course of business. See H.R. Rep. No. 2319, *supra*, at 54. Cf. G.C.M. 236, C.B. VI-2, 27 (1927); Rev. Rul. 55-636, C.B. 1955-2, 17; Tax Guide for U. S. Citizens Abroad, § 10.09 (I.R.S. 1960 ed.). These administrative rulings hold that the proceeds of a sale of a book are not compensation for services, but payments for property. Therefore, such proceeds do not qualify as compensation for purposes of an earned income credit, the retirement income credit, and the exemption for income earned abroad. As the Tax Guide succinctly puts it, the sales proceeds "are not earned income any more than proceeds from the sale of the writer's car or any other item of property would be." See also Reg. 111, § 29.22(a)-9.

taxed as a capital gain, "it proves only that loopholes remain, not that the Court should reopen the one Congress closed." (Resp. 10.)

In other words, the Commissioner blandly dismisses the basic policy, which the tax committees so deliberately confirmed in 1950, as "loopholes." Or, to put it more simply, he is creating his own tax policy for the occasion. At the very least, a loophole is a means of escaping some tax which is otherwise imposed on the taxpayer. But here Congress, after full reflection, decided that the tax otherwise justly due is a capital gains tax. And it ill behooves the Commissioner, in the process of enforcing the tax laws, to dismiss Congress' deliberate choice of policy as "loopholes." Cf. Pet. 96. The Commissioner's loose talk about "loopholes" illustrates the famous adage of Humpty-Dumpty: "When *I* use a word, it means just what I choose it to mean—neither more nor less." However, the question here is what the word means to Congress, not what it means to the Commissioner. And his attempted explanation only confirms again what is already sufficiently clear—that he is at a loss to rationalize his new theory. Various rules of construction "come down to us from sources that were hostile toward the legislative process itself and thought it generally wise to restrict the operation of an act to its narrowest permissible compass." *S.E.C.* v. *Joiner Leasing Corp.*, 320 U.S. 344, 350 (1943). But one can be equally hostile by being overly generous with Congress' words while ignoring its policies. The Commissioner seems more sensitive to such matters when taxpayers try to read statutes in this fashion. Cf. *Corn Products Co.* v. *Commissioner, supra; Commissioner* v. *Lake, supra;* Pet. 23-26, 50-51.

We have by no means exhausted the errors on which this third argument rests. The Commissioner proceeds on the premise that the moneys realized on the sale derived solely from the petitioners' failure to charge for their services. To quote him once more, "In a word, they took out of the corporation in the form of proceeds from the sale of stock neither more nor less than what they put into it in the form of contributed services." If they had been paid, he apparently reasons, the proceeds of the sale would have been *pro tanto* less.

These generalities reflect a good measure of confusion. The value of property at a given time is not determined by the services originally contributed to its construction. It depends on something distinctly different—"the relative intensity of the social desire for it at that time, expressed in the money that it would bring in the market." *Ithaca Trust Co.* v. *United States*, 279 U.S. 151, 155 (1929). Whether property is constructed or purchased, its value, from time to time, is due to changes in market conditions. See p. 26, *supra*.

Again, the Commissioner has confused the petitioners' services with the savings realized on construction. The F.H.A. estimated Springfield's cost of construction at $4,002,959. This sum "was the same in amount as the total of the items of cost for landscape work, utilities, apartments and garages shown therefor in its project analysis." In addition, the construction contract "contained schedules showing an allocation of the said $4,002,959 to the various units of the project to be constructed according to the nature of the work and the materials to be used." This sum did not include any amount for builder's and architect's fees, for the petitioners had waived such fees. (A. 201-203.)

Hence the construction partnership of the petitioners performed the work under a simple reimbursement arrangement. Springfield paid the partnership exactly what it expended for labor and materials. (A.120-121.) The Internal Revenue Service examined the partnership's 1949 return reflecting this arrangement. Gross receipts were shown in the same amount as costs. The Service accepted the return without change. (A. 205.)

"The F.H.A. project analyses estimated replacement cost of the proposed housing projects for a typical builder, rather than for the most or the least efficient builder." *W. H. Weaver*, 25 T.C. 1067, 1075 (1956). As it turned out, the petitioners were more efficient than the typical builder. However, the savings were not monies to which they were entitled for services, since they had duly waived the fees for their services. Indeed, if they had helped themselves to the savings in payment for their services, they would have violated their arrangement with the F.H.A. Evidently, the Commissioner is now exercised because they failed to break their commitment to another executive agency.

The Commissioner's position is no better when we focus on the builder's and architect's fees which are so prominently displayed in the argument. For the Commissioner has plainly misunderstood the role of these fees in the loan arrangements of the F.H.A. He might have found his broad assertions less persuasive if he had been more attentive to the facts. The proceeds from the sale of the stock would have been exactly the same if the fees had been paid. Moreover, there was a very good business reason for waiving the fees.

Under section 608 of the National Housing Act the insured mortgage loan could not exceed 90 percent of

the amount which the F.H.A. estimated as the cost of the development.[24] An application for mortgage insurance was made on a special form provided by the F.H.A. (A. 188-189.) This form directed the applicant to state the total estimated requirements for the development, including the estimated cost of construction, builder's and architect's fees, and carrying charges. (A. 188, 191-192.) The difference between the total estimated requirements and the amount of the mortgage loan was to be supplied by the mortgagor. (A. 189, 191-192.) In accordance with its own estimates and calculations, as set forth in its project analysis (A. 57, 63)[25], the F.H.A. then issued a commitment for insurance. (A. 192-193, 197, 209.) Both the project analysis and commitment required the mortgagor to deposit the amount needed, over and above the mortgage loan, to complete the project. (A. 197, 213.) This amount was the difference between the mortgage loan and the F.H.A.'s estimate of the total cash necessary for completion, including the builder's and architect's fees. (A. 197, 213.) However, the commitment advised the applicant that this amount could be reduced by the sum of the builder's and architect's fees which were not to be paid in cash. (A. 197, 213.)

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[24] 56 Stat. 303 (1942), 12 U.S.C. § 1743 (1946 ed.), as amended by 60 Stat. 214 (1946), 12 U.S.C. § 1743 (1952 ed.), and 61 Stat. 945 (1947), 12 U.S.C. § 1738 (1952 ed.).

[25] We respectfully draw the Court's attention to a printer's error which reversed the fourth pages (A. 60, A. 66) of the project analyses of Springfield and Hill.

In the case of Springfield the F.H.A. computed the total estimated requirements at $4,683,704, including $410,303 for builder's and architect's fees. The estimated cost, not including anything for such fees, was $4,273,401. The mortgage loan was $4,174,800, or $98,601 less than the estimated cost after eliminating the fees. (A. 194.) In the case of Hill the F.H.A. computed the total estimated requirements at $2,162,100, including $189,438 for builder's and architect's fees. The estimated cost, not including anything for such fees, was $1,972,662. The mortgage loan was $1,926,800, or $45,862 less than the estimated cost after eliminating the fees. (A. 210.) As these figures show, the mortgage loan plus the cash to be supplied by the petitioners precisely equalled the estimated cost of construction, after eliminating the builder's and architect's fees. If the corporations' actual costs had been the same as the F.H.A.'s estimated costs, not including the fees, there would not have been any residual mortgage proceeds. A balance was left because the eventual costs were less than the F.H.A. had projected on the basis of its own analyses.[26]

The petitioners waived the fees because it was elementary business sense to do so under the F.H.A. program. For under the requirements of that program

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[26] The Tax Court made calculations designed to show what the mortgage loans would have been if the builder's and architect's fees had not been initially included in the total estimated requirements for the development. (A. 194, n. 3, 210, n. 9.) These computations are completely academic. The fees were included because the F.H.A. required their inclusion under its established method of computing the mortgage loan. Obviously, unless the fees were included in the estimated costs, it made no sense to allow the applicant to reduce the excess over and above the mortgage loan by the amount of the fees, where the fees were not to be paid in cash.

they could not charge for their services unless they put up their own money to pay themselves. As the Tax Court found, if they had not waived the fees, they would have had to raise and contribute the sum of the fees to the project. This further amount would have been about \$600,000—\$410,303 for Springfield and \$189,438 for Hill, or \$599,741 altogether—which the petitioners would have had to furnish to the corporations. (A. 204, 218.) Obviously, it was senseless to incur so huge a financial burden merely to pay themselves, if the burden was unnecessary. And the F.H.A. made it unnecessary by authorizing the waivers. (A. 197, 213. See also A. 111-113.) For that matter, any attempt to impose such a burden would have been absurdly self-defeating. The very purpose of the F.H.A.'s program was to encourage and expedite the construction of rental housing by minimizing the capital required of builders.

Now let us assume that the fees had not been waived. The petitioners would have had to raise the enormous sum of \$600,000 for contribution to the corporations. The same \$600,000 would then have been paid over to them in prior years as builder's and architect's fees. And the net result would be that the underlying property sold would be exactly the same as that actually sold in 1950. In a word, the value of what they sold was completely unaffected by the waiver of the fees.[27] Hence it is highly imaginative to say that the proceeds of the sale were attributable to the waiver of the fees.

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[27] The waived fees bore no relationship to the stock holdings. Petitioner Braunstein would have received the entire amount of architect's fees, which exceeded the builder's fees, and would have shared equally in the builder's fees. (A. 198, 203, 205, 214.) Nor did the waived fees bear any relationship to the respective services. (A. 107, 126, 147-148.)

In his haste to contrive a new argument at this late stage, the Commissioner is equally oblivious to other facts. Through their services, the Commissioner asserts, the petitioners were able "to convert the 'savings' into an increase in the value of their equity" in the development—that is, "by creating" structures "presumably" worth considerably "more than they cost (and, hence, more than the mortgage indebtedness to which they were subject)." The Commissioner then reasons that the petitioners realized this "increase in the value of their equity," over and above the cost and mortgage indebtedness, through the proceeds of the sale. (Resp. 24-25.) The Commissioner freely forgets what he well remembers elsewhere in his brief. (Resp. 6-7.) A large part of the proceeds—$555,000 out of about $950,000—did not in any way reflect the market value of the buildings. It simply represented the accumulated cash on hand in the two corporations.

At the time of the sales negotiations the corporations had substantial amounts of cash. This cash consisted of the residual mortgage proceeds and accumulated rental income. The rental income had been fully offset on the corporate returns by deductions for depreciation, and additional deductions for interest and taxes, incurred as a cost of the development. (R. 1-2, 27; A. 44, 45, 224-226, 239-241.) The purchasers insisted, as part of the terms of sale, that the corporations distribute all but nominal amounts of cash to the petitioners. (Pet. 5.) Pursuant to the agreement of sale Springfield accordingly distributed $410,000, and Hill $145,000, or a total of $555,000. Cf. *Steel Improvement & Forge Co.* v. *Commissioner*, 63-1 U.S.T.C. ¶ 9318 (6th Cir. 1963). This large share of the sales proceeds, then, represented a partial recovery of the

cost of the development and a portion of the mortgage indebtedness. Hence even under the Commissioner's newly discovered theory of "gain" attributable to the property—the "conversion" of "contributed services" —the $555,000 cannot be made to qualify as a so-called "increase" in equity in the buildings beyond their cost and "the mortgage indebtedness to which they were subject."

The Commissioner disregards still another matter in the pursuit of his argument. According to his newly devised theory, the profit on the sale is "gain attributable to" the constructed property within section 117(m), because the petitioners did not charge the corporation "for architectural, general contracting, and subcontracting services." (Resp. 9-10.) The proceeds are deemed a conversion of ordinary income imputed to these services. Even if this far-fetched notion were for some reason correct, the corporations would not be collapsible. Under section 117(m) it is not enough that the shareholders realize, through the sale of their stock, the "gain attributable to" the constructed property. In addition, the corporation must be used for the construction of property "with a view to" the realization of that gain. (Pet. 20-21.)

As the Commissioner agrees, the significant phrase "with a view to" means "calculating upon or contemplating as a desired result." (Pet. 61-62.) The realization of the gain, then, must have been planned or contemplated. (Resp. 2, 8, 12; Brief for Resp. on Pet. for Cert. 2, 4-5). "Contemplation," this Court has held, is not some "general expectation" that "all entertain. It must be a particular concern, giving rise to a definite motive." *United States* v. *Wells*, 283 U.S. 102, 115 (1931). Therefore, under the Commissioner's

newly conceived theory—even if it were otherwise tenable—the corporations were not collapsible unless the fees were waived for the specific purpose of later realizing the gain now imputed to the fees. For "a deed is not done with intent to produce a consequence unless that consequence is the aim of the deed." *Abrams* v. *United States*, 250 U.S. 616, 627 (1919) (dissent). But as the evidence and findings plainly show, the waiver was not remotely prompted by any such purpose. See pp. 42-43, *supra*. The fees were waived because of genuine business considerations.

The story is no different with regard to the alleged conversion of ordinary income which the Commissioner imputes to the "subcontracting services." The items involved are plumbing, heating, and carpentry. Here, also, the Commissioner has paid no attention to the evidence and findings in his zealous pursuit of his new theory. On prior F.H.A. projects the petitioners had hired contractors to do the plumbing and heating work. (A. 227.) In estimating the costs for Springfield and Hill the petitioners had assumed that they would do the same. (A. 227.) They had similarly assumed that the carpentry would be handled by a contractor or contractors. (A. 227.) In accordance with these plans the petitioners solicited bids from plumbing and carpentry contractors. (A. 227.) They finally considered the bids too high, and decided to proceed without contractors. (A. 227.) The carpentry work was handled by an employee who had served as their superintendent for many years. (A. 227.) The plumbing and heating work was supervised by a master plumber. (A. 118, 227.) As a result, the Tax Court found, there were "savings which the petitioners had not expected at the outset." (A. 227-228.) The car-

pentry work was about $80,000 less than originally estimated, and the plumbing and heating work about $85,000 less. (A. 227.) These savings had nothing to do with any "blatant" plan or scheme to realize some later profit. They were prompted by normal commonsense business reasons.

In a final effort to justify his third argument, the Commissioner turns to the motion picture industry. "The basic abuse" in the movie industry, he states, was "the conversion of the values in producing the movie through the stockholders' contributed services into capital gain." (Resp. 34.) This statement is plainly wrong. As the extensive legislative history shows, the abuse was that the stockholders realized, as a capital gain, the ordinary, everyday profits from the picture which are normally realized, either individually or through the corporation, as ordinary income. See also pp. 2-3, *supra*. And as the same history further shows, this conversion was effected through a liquidation of the corporation. The value of the picture was reported as a capital gain on the liquidation, and the normal rental income received by the stockholders, rather than the corporation, was cancelled out by amortizing the value of the film against that income. (Pet. 72.)

The Commissioner asserts that apartment buildings are just like motion pictures, except for a minor difference in "the locale and the cast of characters." (Resp. 34.) And then he applies this generality to the present case. Yet, despite this display of confidence, the legislative history does not include the slightest reference to apartment buildings. While the hearings and reports express concern over tax avoidance in the construction industry, the concern is solely with builders who construct houses for sale to customers in

the ordinary course of their business. (Pet. 72.) There is no mention whatever of builders who construct apartment developments for rental, as distinguished from sale in the ordinary course of business. The difference in attitude, we believe, is easily explained. If a builder who owns and operates such an apartment development eventually sells it, the profit is a capital gain. Similarly, if he owns and operates the building through a corporation which later sells it, the profit is also a capital gain. And so there is no reason to be disturbed over a sale of the stock instead of the property. The sale does not convert ordinary income from the property into capital gain.

Of course, as the Commissioner notes, a builder of an apartment development might try to emulate a movie producer by liquidating his corporation and then writing off the value of the building against his rental income as continuing owner of the property. But, as the Commissioner fails to add, the tax incentives for the builder are hardly comparable to those of the producer. In the case of the movie the rental income is received in a very short time, and all the value realized as a capital gain on the liquidation is quickly written off against that income. The period of amortization ranges between one and two years. Even if the period runs beyond one year, almost all the income and write-off falls within the first year.[28] On the other hand, in the case of the apartment building the period of write-off is far longer. Until recently the Commissioner held that the useful life of an apartment building for purposes of depreciation varies between 33⅓ and 40

[28] Tannenbaum, *Amortization of Motion Pictures*, 1948 Proc. U.S.C. Tax Inst. 345, 347-348 (1949).

years.[29] Now he fixes the useful life at 40 years.[30] The attempted conversion of continuing rental receipts into capital gain through a corporate liquidation is by no means as attractive as the Commissioner assumes. The stockholder must immediately pay a large capital gains tax, and the gain is not quickly written off against rentals as in the movie industry.

In any event, it makes no difference even if such a conversion were more attractive. In the first place, the profit realized here on the sale was not a conversion of ordinary business profit from the development into capital gain. The question is not whether the petitioners sold or exchanged their stock at a profit, but whether the disposition enabled them to realize the "gain" that section 117(m) taxes as ordinary income in accordance with its true economic content. Here there was no such "gain." There was no attempt to transmute continuing rental receipts into capital gain.[31] In the second place, here the petitioners were not even able to effect such a conversion through a liquidation—even if they had wanted to do so. For the Administrative Rules of the F.H.A. prohibited them from liqui-

[29] Bulletin F, Tables of Useful Lives of Depreciable Property, I.R.S. Pub. No. 173, p. 7 (1955).

[30] Depreciation Guidelines and Rules, I.R.S. Pub. No. 456, p. 12 (1962).

[31] The Commissioner states: "The statute makes nothing turn on whether the corporation is liquidated or the stock sold." (Resp. 34, n. 31.) This is a delusive half-truth, which ignores the committee reports. Section 117(m) includes sales of stock as well as liquidations in order to reach those cases where a sale raises "the same tax questions" as a liquidation. (Pet. 35, 73.) And those "same tax questions" are the realization of the ordinary income of the property as a capital gain. Nothing turns on a liquidation or sale as such—but on whether a liquidation or sale produces, with the required "view" or purpose, the particular profit with which the statute is concerned. (Pet. 71-76.)

dating the corporations and operating the development as individuals. Administrative Rules of the F.H.A. for War Rental Housing Insurance, §§ 580.26, 580.29. See Appendix B, *infra*, p. 3a. In brief, the petitioners could not realize the ordinary income from the development as a capital gain, because the sole means of effecting such a conversion was closed to them. They could not in any way engage in the tax avoidance which the statute set out to prevent.[32]

In fact, the results of the Commissioner's construction are so unreasonable as to raise a constitutional question of irrational discrimination under the Fifth Amendment. Unlike the Fourteenth Amendment, the Fifth Amendment does not contain an equal protection clause. "But the concepts of equal protection and due process, both stemming from our American ideal of fairness, are not mutually exclusive." And "as this Court has recognized, discrimination may be so unjustifiable as to be violative of due process." *Bolling* v. *Sharpe*, 347 U.S. 498, 499 (1954). See *Heiner* v. *Donnan*, 285 U.S. 312, 326, 331 (1932); *Tyler* v. *United States*, 281 U.S. 497, 504 (1930). Limitations like the Fifth Amendment "are admonitions of fair dealing, whose disregard the courts will correct, if extreme and glaring." *Cohan* v. *Commissioner*, 39 F. 2d 540, 545 (2d Cir. 1930).

The Commissioner's interpretation is so capricious as to violate the basic standard of fairness implicit in due process. Here, according to the Commissioner,

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[32] The Commissioner notes that the F.H.A. required the petitioners to operate through a corporation. (Resp. 26, n. 25.) This only emphasizes all the more that section 117(m) should not be construed so as to penalize taxpayers for using a corporation—especially where they were fully barred from converting the ordinary income from the property into capital gain.

Congress has deliberately and arbitrarily distinguished between doing business as an individual and doing business through a corporation. The same profit is taxable as capital gain in one case and ordinary income in the other. And again, according to the Commissioner, even in the case of a corporation Congress has deliberately and arbitrarily distinguished between a sale of stock and a sale of the underlying assets. The Commissioner's construction is particularly irrational here because the petitioners had no choice in the matter. They had to do business through a corporation. See *DuPont* v. *Commissioner*, 289 U.S. 685, 688 (1933). The admonition of fair dealing in the Fifth Amendment reinforces our view that section 117(m) should be sensibly construed.

The Commissioner tries to make something out of the basis of the property to the purchaser. He observes that when shareholders sell their stock in a corporation holding an apartment development, the buyer can liquidate the corporation and so obtain a higher basis for depreciation—namely, his purchase price for the stock. As a result, the purchaser can depreciate his higher basis, rather than the lower basis of the corporation, against the rental receipts. (Resp. 35.) We are at a loss to understand what this impeccable observation contributes to the present case. If builders own, operate, and sell an apartment development as individuals, the buyer also has a stepped-up basis for depreciation. Again, if they own it through a corporation and the corporation itself sells the development, the buyer similarly has a stepped-up basis. The sale of the stock, followed by a liquidation, does not in any way change the situation. Moreover, section 117(m) is not concerned with the basis of the property to the

purchaser. Its one and only concern is the nature of the profit realized by the seller.

But, more important, the Commissioner's observation on basis has a strange ring here. For here the buyers did not even obtain a stepped-up basis after the sale. As the Tax Court found, "Springfield and Hill continued as owners" of the development. (R. 18.) Therefore, the depreciation deductions against the income from the property continued to be computed on the original lower costs of construction incurred by the corporations. Furthermore, the controlling Rules of the F.H.A. also barred the purchasers from liquidating the corporations. See p. 49, *supra*. On the other hand, if the petitioners had owned and sold the development as individuals, or if the corporations had sold the development, the depreciation deductions would have been higher because they would have been based on the higher purchase price. To summarize the matter, the rental income subject to tax after the sale was larger than it would have been if the petitioners or the corporations had directly sold the assets. In view of all the talk of tax avoidance, we can well understand the Commissioner's failure to so advise the Court. Instead of losing revenue, the Government actually gained revenue.

The Commissioner complains that if our position is correct, then movie producers can continue to convert ordinary income from films into capital gain by regularly selling their stock instead of liquidating their corporations. (Pet. 35.) This conclusion does not in the least follow. In fact, a few observations discreetly placed in a footnote reveal that the Commissioner himself is uncomfortably aware that he has overstated his argument. (Resp. 36, n. 33.) The answer

is provided by subsection (a)(1)(C) of section 117, which was enacted at the same time as subsection (m). See p. 28, *supra*. Under subsection (a)(1)(C) a motion picture sold by those whose efforts produced it would not qualify as a capital asset. Therefore, the income realized on a direct sale of the picture would be ordinary income. From a tax standpoint such property is deemed property held primarily for sale to customers in the ordinary course of business.[33] By the same token, if the same taxpayers sought to realize the same profit by production through a corporation and a quick sale of its stock, the profit would be "gain attributable to such property" within section 117(m). For the profit would be an attempted conversion of ordinary income from the property into capital gain.[34] The Commissioner attempts to sidestep the interrelationship of the two subsections by saying: "Nothing in the history, however, suggests that Congress' purpose in § 117(m) to proscribe the corporate abuse typified by the movie example was derived from or dependent upon the amendments to the 'capital asset' definition." (Resp. 36, n. 33.) However, the committee reports clearly indicate the close relationship of the two—that subsections (a)(1)(C) and (m) are to be applied together toward the same common end. See pp. 29-31, *supra*.[35]

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[33] The regulations do not specifically refer to motion pictures. However, they include within section 117(a)(1)(C), by way of example, "a radio program" and "a theatrical production." Reg. 111, § 29.117-1, *supra*.

[34] The situation would be akin to the construction of homes for sale to customers in the ordinary course of business. (Pet. 30, 33-35, 72-74.)

[35] We cannot understand why the Commissioner is particularly disturbed over motion pictures, quite apart from section 117(a) (1)(C). The Commissioner has held that profit realized by a pro-

Indeed, when all the smoke clears away at the end, it turns out that the Commissioner's repeated talk of contributed services is quite irrelevant. In the Commissioner's own words of admission, "it is important to reemphasize what is of the essence and what is not." It is enough that the corporation has simply engaged in the "manufacture, construction, or production of property." Again, in the Commissioner's words, "the specific identity of the factors primarily responsible for the values created in those processes (capital, labor, know-how, sound market analysis, or whatever) is ultimately immaterial." The statute "reaches all gains 'attributable to the property so manufactured, constructed, or produced' regardless of whether they represent only the normal profits of manufacturing and construction (the values added simply by combining the necessary factors of production to create an economically useful product)." "The surest guide to the intended scope of the statute is its own terms," and what "should control, quite simply," is that the corporation was used for construction. (Resp. 37.) The various words on contributed services, then, are mere diversionary observations. Or, perhaps, they are only

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ducer on a sale of motion picture films is ordinary income because, given the special going market for films, they are usually held for sale to customers in the ordinary course of business. Rev. Rul. 62-141, I.R.B. 1962-35,9. It follows, then, that if stockholders sought to realize the same profit from the films through a sale of stock, they would realize precisely the gain encompassed by the collapsible statute. In the same ruling the Commissioner concedes that there may be some cases, depending on the particular circumstances, where a producer sells a film not held for sale to customers in the ordinary course of business. If the profit in such cases is a capital gain, then there is no conversion of ordinary income from the film into capital gain if stock is sold instead of the film. The Government is not being deprived of any revenue, and the collapsible statute should not apply.

rhetorical flourishes designed "to beautify what is disagreeable to the sufferers." *Tyson & Bro.* v. *Banton*, 273 U.S. 418, 446 (1927) (dissent). Under the Commissioner's understanding of the statute, as it frankly emerges at the end, any profit realized upon constructed property falls within section 117(m). And any such profit, he insists, necessarily constitutes a "conversion of ordinary income into capital gain." (Resp. 37-38.)

CONCLUSION

Subsection (m) of section 117 is a segment of a comprehensive legislative scheme on the subject of capital gains. (Pet. 22.) And so the question here is precisely the same as the question commonly asked in applying section 117. Is the receipt involved the kind of profit to which the particular provision was addressed? (Pet. 23-26.) "We can best reach the meaning here, as always, by recourse to the underlying purpose" of the statute. *Borella* v. *Borden Co.*, 145 F. 2d 63, 64 (2d Cir. 1944), *aff'd*, 325 U.S. 679 (1945). And in implementing that purpose, "we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy." *Mastro Plastics* v. *N.L.R.B.*, 350 U.S. 270, 285 (1956). Insofar as we can tell, amid the various elements of error and confusion in his brief, the Commissioner agrees with these basic principles. He prominently protests that he, too, firmly believes that statutes should be read so as "to carry out the discovered purposes of Congress." And, along the same lines, he emphasizes that "absurd results" should be meticulously shunned, and a determined effort always made "to produce a rational, sensible structure." See p. 7, *supra*. Having made his professions of faith, the Commissioner rapidly forgets what he has said.

We have here a statute framed largely in colloquial language. But "the colloquial words of a statute have not the fixed and artificial content of scientific symbols; they have a penumbra, a dim fringe, a connotation, for they express an attitude of will, into which it is our duty to penetrate and which we must enforce ungrudgingly when we can ascertain it, regardless of imprecision in its expression." *Commissioner* v. *Ickelheimer*, 132 F. 2d 660, 662 (2d Cir. 1943) (dissent).[36] See also *Universal Camera Corp.* v. *Labor Board*, 340 U.S. 474, 489 (1951). Here the legislative purpose to be ungrudgingly enforced is plainly articulated in the legislative hearings and reports. The one and only problem with which section 117(m) is concerned is the studied attempt to realize the ordinary income from constructed property as a capital gain by means of incorporation and a sale or exchange of stock. In short, it is concerned with tax avoidance. There has been no such realization or avoidance here. The incorporation and sale have not enabled any ordinary income to escape the normal tax that would otherwise be due. In fact, the Commissioner is collecting more tax than would have been due if the petitioners had owned and sold the property as individuals. See pp. 51-52, *supra*. To construe the statute as the Commissioner does is to produce the very "absurd results" which, at least formally, he deplores. For as he would apply the statute, capital gain is converted into ordinary income. Section 117(m) is turned into a penal levy against those who realize bona fide capital gains through a sale of stock instead of the underlying property.

Throughout his brief the Commissioner has noticeably refrained from trying to explain why Congress

[36] This dissent was later sustained in *McWilliams* v. *Commissioner*, 331 U.S. 694 (1947).

should have desired or imposed such a result. The Court of Appeals itself indicated that the result here is "unwarranted taxation of capital gains as ordinary income." (R. 36.) As the Commissioner's brief comes to a close, all he can finally do is to fall back on the so-called "letter" of the statute. He "has no answer except to say that we are not free to depart from the literal meaning of the words, however transparent may be the resulting stultification of the scheme or plan as a whole." *Cabell* v. *Markham*, 148 F. 2d 737, 739 (2d Cir. 1945), *aff'd*, 326 U.S. 404 (1945). Here, of course, his so-called "literal" meaning is neither literal nor sensible. (Pet. 41-52.)[37] Even if the issue were more doubtful, the appropriate answer is the one that makes sense. So subsection (a) is construed, and so subsection (m) should be read. For they are interrelated parts of the same statutory scheme. (Pet. 51-52.) We submit that before a taxpayer is subjected to a heavy tax deficiency, the relevant statute should, at the very least, be construed in accordance with the purpose of Congress.

The nature of the Commissioner's construction is sufficiently shown by the distinction he would make between operating an enterprise as an individual and operating it through a corporation. In pursuit of its underlying purpose, section 117(m) seeks to equate the tax treatment of the two. It precludes a taxpayer from converting ordinary income into capital gain

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[37] Cf. Hand, The Spirit of Liberty 156-157 (1952): "The duty of ascertaining its meaning is difficult enough at best, and one certain way of missing it is by reading it literally, for words are such temperamental beings that the surest way to lose their essence is to take them at their face. Courts must reconstruct the past solution imaginatively in its setting and project the purposes which inspired it upon the concrete occasions which arise for their decision."

through the process of incorporating the enterprise. However, the Commissioner's interpretation produces exactly the opposite result. If the petitioners had built and operated Oakland Gardens in their individual capacity, the profit realized on its sale would have been capital gain. According to the Commissioner, the same profit realized through a sale of stock is ordinary income. And this arbitrary incongruity, completely at odds with the aim of the statute, the Commissioner regards as a genuine "effort to produce a rational, sensible structure" in accordance with "the discovered purposes of Congress."

Only recently this Court disposed of a similar mode of construction in *United States* v. *Gilmore*, 372 U.S. 39 (1963). There, as here, an attempt was made to entangle the application of a tax statute in a distinction between an individual enterprise and a corporate enterprise. The Court refused to approve such "incongruities" of interpretation. As the Court stated, "It was manifestly Congress' purpose" in the area involved "to place all income-producing activities on an equal footing. And it would surely be a surprising result were it now to turn out that a change designed to achieve equality of treatment in fact had served only to reverse the inequality of treatment." *Id.* at 49. The Commissioner is trying to produce the same "surprising result" here, after deploring it in the *Gilmore* case. As he reads section 117(m), it is some special penalty imposed on those who do business through a corporation—even when they have to do business that way. See p. 49, *supra.* Compare, in regard to arbitrary incongruities, *Putnam* v. *Commissioner*, 352 U.S. 82, 92-93 (1956); *Colony, Inc.* v. *Commissioner*, 357 U.S. 28, 36-37 (1958).

One small matter remains. The Commissioner states that if our construction of the statute is correct, it is necessary to remand the case to the Tax Court. (Resp. 31, n. 28.) This suggestion, we gather, rests on the ground that the petitioners individually may have been in the business of constructing and holding apartment buildings primarily for sale to customers in the ordinary course of their business. However, there is no reason for any further proceedings here. The evidence and findings could not possibly permit any such conclusion in favor of the Commissioner. "To remand the cause for further findings would be futile." The Tax Court "could not properly find anything which would assist the Commissioner's cause." *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200, 207 (1935). Cf. *United States* v. *Wells*, *supra*, at 120-121; *O'Leary* v. *Brown-Pacific-Maxon*, 340 U.S. 504, 508 (1951); *Jacobson* v. *Commissioner*, 281 F. 2d 703, 706 (3d Cir. 1960).

As the findings and the uncontradicted evidence disclose, at no time throughout their careers in real estate did the petitioners hold, within section 117(a)(1)(A), apartment buildings or other rental properties primarily "for sale to customers" in "ordinary course." They were not dealers in such structures. (A. 99, 101, 106, 186, 250.) See also Pet. 3-4, 6.[38] Otherwise the opinion below was an academic exercise. Its entire discussion rests on the premise that if the petitioners had realized the same profit as direct owners of the property, it would have been capital gain. The very

[38] It was stipulated, as well as found, that the petitioners were not holding their stock in the corporations primarily for sale to customers in the ordinary course of business. (Pet. 39, n. 7.) And, needless to add, the Commissioner does not claim that the corporations were holding the development for any such purpose.

heading of the court's discussion states: "Section 117(m) applies even if sale of the corporate assets would have produced capital gain had no corporation existed." (R. 35.) Finally, the Commissioner himself agreed that the petitioners were not in the business of selling apartment buildings to customers in ordinary course, when he framed the question which is now before the Court. See p. 4, *supra*.

Respectfully submitted,

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APPENDIX A

UNITED STATES TREASURY DEPARTMENT,
INTERNAL REVENUE SERVICE,
WASHINGTON, D. C., NOVEMBER 30, 1950.

Shirley-Duke Apartments, Section III, Inc.,
Alexandria, Va.

(Attention Mr. Carl Budwesky, secretary.)

Gentlemen: Reference is made to your letter dated October 18, 1950, requesting a ruling as to the status, for Federal income tax purposes, of a proposed distribution to your stockholders.

It is stated that the corporation was organized under the laws of the State of Virginia for the construction and operation of an apartment development. It began construction in June 1949, which was financed by a mortgage loan of $1,840,000. There are issued and outstanding 100 shares of first preferred stock of a par value of $1 per share and 200 shares of common stock of no par value issued on a basis of $5 per share.

The project was constructed by the corporation through its employees, who supervised the operations and let contracts for the various types of work to numerous contractors. Four of the stockholders were employed in this connection, and the compensation paid to them is set forth in your letter.

The construction has been completed, all costs have been paid, and there is remaining $100,000 of the proceeds of the mortgage loan which the board of directors has transferred to capital account. It is proposed to distribute this sum to the shareholders in proportion to their holdings of stock. All such shareholders have held their respective shares for more than six months.

Based upon the representations in your letter it is held that upon distribution the amount distributed shall be

applied against and reduce the basis of the stock held by the receiving shareholder and shall be taxable to the recipient if, and to the extent that, the amount distributed exceeds such basis. The gain, if any, will constitute long-term capital gain in accordance with the provisions of section 117(b) of the Internal Revenue Code.

Very truly yours,

E. D. McLarney,
Deputy Commissioner

APPENDIX B

Administrative Rules for War Rental Housing Insurance Under Section 608, National Housing Act

(24 CFR, 1947 Supp., 580.1 to 580.41)

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§ 580.26 *Requirements Regarding Form of Mortgagor.* In addition to meeting the requirements set forth in §§ 580.23 to 580.25, inclusive, the mortgagor must be:

(a) a corporation or trust formed or created, with the approval of the Commissioner, for the purpose of providing housing for rent or sale, and possessing powers necessary therefor and incidental thereto, which corporation, or trust, until the termination of all obligations of the Commissioner under such insurance, is regulated or restricted by the Commissioner as to rents or sales, charges, capital structures, and methods of operation to such an extent as may be deemed advisable by the Commissioner. Such regulation or restriction shall remain in effect until such time as the mortgage insurance contract terminates without obligation upon the Commissioner to issue debentures as a result of such termination. So long as such contract of insurance is in effect, the corporation or trust shall engage in no business other than the construction and operation of a Rental Housing project or projects . . . .

* * *

(c) if the mortgage is not in excess of $200,000, the mortgagor may be an individual.

* * *

§ 580.29 *Regulation of Mortgagor by Commissioner in General.* A corporate mortgagor shall be regulated through the ownership by the Commissioner of certain shares of special stock (or other evidence of beneficial interest in the mortgagor) which stock or interest will acquire majority voting rights in the event of default under the mortgage or violation of pro-

visions of the charter of the mortgagor or the violation of any valid agreement entered into between the mortgagor, the mortgagee and/or the Commissioner, but only for a period coextensive with the duration of such default or violation. The shares of stock or beneficial interest issued to the Commissioner, his nominee or nominees and/or the Federal Housing Administration shall be in sufficient amount to constitute under the laws of the particular State a valid special class of stock or interest and shall be issued in consideration of the payment by the Commissioner of not exceeding in the aggregate $100. Such stock shall be represented by certificates issued in the name of the Commissioner, and/or in the name of his nominee or nominees, and/or in the name of the Federal Housing Administration, as the Commissioner shall require. Upon the termination of all obligations of the Commissioner under his contract of mortgage insurance or any succeeding contract or agreement covering the mortgage obligation, including the obligation upon the Commissioner to issue debentures as a result of such termination, all regulation and restriction of the mortgagor shall cease. When the right of the Commissioner to regulate or restrict the mortgagor shall so terminate, the shares of special stock or other evidence of beneficial interest shall be surrendered by the Commissioner upon reimbursement of his payments therefor plus accrued dividends, if any, thereon. Such regulation and the additional regulation or restriction hereinafter provided in §§ 580.30 to 580.32, inclusive, shall be made effective by incorporation of appropriate provisions therefore in the charter or other instrument under which the mortgagor is created, or by agreement.

* * *

§ 580.41 *Effective Date.* This part is effective as to all mortgages on which a commitment to insure under section 608 is issued, on or after December 19, 1947, pursuant to an application for mortgage insurance filed on or after said date.